

EXCHANGE RATES AND THIRD WORLD DEBT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE RECENT DEVELOPMENTS IN THE PARIS TALKS ON EXCHANGE
RATES, THE LOAN PACKAGE FOR MEXICO ASSIGNED BY THE BANK
LENDERS, THE BRAZILIAN DECISION WITH RESPECT TO ITS FOREIGN
BORROWINGS AND THE IMPACT ON THE U.S. BALANCE OF TRADE

MARCH 26, APRIL 1, 2, AND 7, 1987

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EXCHANGE RATES AND THIRD WORLD DEBT

THURSDAY, MARCH 26, 1987

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:40 a.m., in room SD-562, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Dixon, Graham, Heinz, and Gramm.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

This is a further hearing in a series that the Subcommittee on International Finance and Monetary Policy has been conducting in preparation for looking at issues over which the Banking Committee has jurisdiction, which would be relevant with respect to the trade bill, when it is considered on the floor of the Senate. But today, we are going to look at a double issue and will be addressing these issues in the subsequent hearings, at least in part, of exchange rates and Third World debt. Both the value of the dollar and the debt burden of Third World countries has had, I think most observers would conclude, a significant impact on the U.S. balance of trade.

Recent developments in the Paris talks on exchange rates, the loan package for Mexico assigned by the bank lenders, the Brazilian decision with respect to its foreign borrowings, all make this hearing particularly timely.

We will start off and hear from the Assistant Secretary of the Treasury for International Finance, David Mulford. We will then follow Secretary Mulford with a panel of economists to comment on these issues—Peter Kenen of Princeton, Fred Bergsten of the Institute for International Economics, Richard Cooper of Harvard and Rimmer DeVries of Morgan Guaranty.

Senator Heinz?

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. I am glad to see David Mulford here. I might just observe, as we resume an assessment by this subcommittee on the problem of exchange rates and developing countries' debt, that this subcommittee, when I was its chairman, did pursue solutions to these problems in a series of subcommittee hearings in the last Congress.

I would also observe that I am prepared to forego any credit for the modest progress that has been made realigning the dollar against the yen and mark and averting another debt crisis. In fact, one reason I won't claim credit is because the gains made have been very modest, indeed, at least on the debt crisis. And while it would be consoling to believe that the monetary system is finally working properly, it is also hard to demonstrate that. Although the dollar has declined 30 percent against the G-10 currencies since its peak in early 1985, and Germany and Japan have pledged to stimulate their growth and demand in their economies, the dollar is still 22 percent above its nominal level against the G-10 from where it was in 1980, prior to the run up of the dollar.

And I must say, I am not holding my breath for Germany and Japan to follow through on policy reforms that aid us at the expense of their exporters. Japan has actually dropped its steel prices in the United States 4 percent since last year, despite a 40 percent rise in the yen. Matters look worse if we expand our analysis to include major developing countries that now account for nearly 40 percent of U.S. trade.

The dollar has fallen only 12 percent since early 1985 and is a stunning 68 percent higher in nominal terms, since 1980. The major newly industrializing countries are both manipulating their currencies to gain competitive advantage and making no pledges to increase demand for our benefit. So we have got a long way to go on exchange rates.

I can't say I am a lot more hopeful on the debt problem. We have seen no new financial crises, I suppose, although cases of sustained recovery are also hard to come by. Countries pursue policy reform for a while, but at the first sign of recovery, they seem to go off the track again. Most debtors seem to languish on the regulators' impaired country list.

So Mr. Chairman, I commend you on these hearings. I think these problems are vital to our future competitiveness.

I want to just add a word of commendation for David Mulford and the Treasury Department. They have really worked hard and tirelessly and energetically, and as well as they know how—and they have a lot of know-how on these issues. But if you don't get the kind of cooperation that either is pledged to you by the other side, or the other side is just unwilling to cooperate, there is not a lot that we can do, unilaterally, on some of these issues. In that case, we can only get our own house in order and try to do a better job on that score.

So I look forward to hearing Secretary Mulford and our other witnesses.

Senator SARBANES. Thank you very much, Senator Heinz. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me say that I remember vividly that dark day when Richard Nixon imposed wage and price controls and went on flexible exchange rates. The wage and price control decision was an unmitigated disaster. It created more economic pressures, which ultimately made the inflation rate, as it

unfolded over the next decade, higher than it would have been without the wage and price controls, but I think the Nixon decision to go on flexible exchange rates was a wise decision and has served the nation well.

There is something in the bosom of every Secretary of the Treasury, no matter who that may be, including my dear friend, Jim Baker, that they want to defend the dollar, that they want to set exchange rates, that they want to try to coordinate exchange rates. And I have to admit that I have trouble taking that whole effort seriously, when we have \$100 billion of transactions occur on what is the world's most perfect market. The idea that we are somehow going to, on any kind of permanent basis, change the value of the dollar relative to foreign currencies, unless we can affect underlying factors that affect the supply and demand for dollars, borders on being laughable.

I salute the effort to try to encourage our trading partners to stimulate their economies through reducing marginal tax rates and by expanding monetary policy within sound limits. I think that can be helpful. But the idea that we can intervene in the currency market, that we can make the value of the dollar relative to foreign currencies what we want it to be in some abstract public policy objective is absolutely ridiculous. It is a waste of the taxpayers' money. It cannot be successful. And the plain truth is that while we, in many cases, would like to have the advantages of a fixed exchange rate, and that is that, various elements of our economy can look at a fixed exchange rate and see how they might benefit from it, I think it is important for all of us to understand that fixed exchange rates work only if you are willing to adjust your economy internally to make the adjustment mechanism work.

Fixed exchange rates work, if you're losing foreign exchange only, if you are willing to deflate your economy.

I submit, Mr. Chairman, that the United States is not willing to do that, nor are our trading partners willing to inflate their economy because of a surplus in the balance of trade.

In fact, since the end of World War I, fixed exchange rates have worked nowhere. So I think it is vitally important that we debate these issues, but I think it is important to recognize that we don't exist in a vacuum, that there is a huge world market, that there is a huge world exchange market, that, relatively speaking, we are a modest player in that market, and to act otherwise, I think, is to dream grandiose dreams that cannot come true.

Senator SARBANES. Thank you, Senator Gramm. Senator Dixon had to leave and asked that his statement be inserted in the record.

[Senator Dixon's statement follows:]

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I'm pleased to be here this morning as the subcommittee takes testimony on exchange rate and Third World debt issues. We have a distinguished and knowledgeable group of witnesses before us today, and I look forward to hearing their testimony.

As everyone here knows, the United States is experiencing record trade deficits. Although the dollar has come down dramatically, the improvement that should occur in our overall trade position has been very slow to appear.

Exchange rate issues and the role of intervention are currently receiving considerable attention. I continue to believe that exchange rates reflect economic fundamentals between countries over the long run and that even coordinated intervention cannot maintain exchange rates at levels not dictated by market positions. However, intervention does have a role to play, and I look forward to the comments of today's witnesses on the intervention issue and broader exchange rate concerns.

On the issue of Third World debt, let me clearly state my deep respect for Secretary of the Treasury Baker, and his devoted efforts to the Third World debt issue. However, I believe the "Baker plan" is nothing more than another quick fix and not a comprehensive economic solution to the LDC issue. The recent halt of payments by Brazil and the continuing problems of other debtor nations tells me that we must address this problem soon before the situation becomes much, much worse.

U.S. banks are dangerously overexposed in Latin America and it seems to me that additional loans to pay the interest on old loans without generating new economic growth in these nations does not address the real problem, nor does it make any sense. Neither the leading debtor countries or the U.S. banking industry benefit from new loans primarily granted to finance more debt. This policy continues to buy time and avoids addressing the heart of the problem.

As I have said before, I am not advocating cutting off further LDC lending for debt service purposes, or requiring banks to write off some of their LDC debt, but we must address the fundamental problems behind the LDC debt crisis now. The LDC debt problems we have already experienced could grow much worse, with much more serious impact on the U.S. banking system, unless we begin to do more than simply continue to apply temporary fixes on this situation.

I look forward to hearing the views of this morning's witnesses on exchange rates and Third World debt.

Senator SARBANES. Secretary Mulford.

STATEMENT OF DAVID MULFORD, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS.

Mr. MULFORD. Thank you, Mr. Chairman. I have a prepared statement, which I would like to submit for the record.

If you will permit me, I would like to read a 6 or 7-minute brief summary of that, in order to get us started here this morning.

Senator SARBANES. We will include the full statement in the record. You may proceed.

Mr. MULFORD. Thank you very much.

Mr. Chairman, members of the subcommittee. I welcome this opportunity to discuss our efforts to reduce the U.S. trade deficit, improve the operation of the international monetary system and deal with the international debt problem.

REDUCING OUR TRADE DEFICIT

The Administration's approach to reducing our trade deficit is now embodied in our proposals to improve the ability of the United States to compete in the world economy, for which legislative language was submitted February 19th.

Our approach to shaping the international economic environment has been designed, in large part to respond to 3 broad causes of the deterioration in our trading accounts in the 1980's: the strength of the dollar, U.S. economic performance relative to that of the other major industrial countries and the LDC debt situation. Thus, while pursuing an aggressive, comprehensive trade policy, we have focused a great deal of time and attention on one, strengthening international economic cooperation among the major industrial nations to achieve exchange rates in line with economic fundamentals and to promote balanced growth and on, two, developing a strategy to deal with problems of the heavily indebted developing countries.

The Plaza Agreement of September 1985 marked a major turning point in our efforts to achieve close, international economic cooperation. Building on the Plaza Agreement, the leaders of the free world's major democracies meeting in Tokyo last May agreed on a framework for closer coordination of economic policies among their countries, using a range of economic indicators. The February 22 meeting in Paris of Finance Ministers and Central Bank Governors of a number of major industrial countries carried this process forward by agreeing on concrete steps to promote improved and more balanced global growth and smaller trade imbalances.

In the past 2 years, substantial exchange rate changes have occurred, with the dollar depreciating by 40 to 50 percent against the currencies of the other major industrial countries. About two-thirds of that shift has taken place since the Plaza Agreement. This exchange rate adjustment has helped to halt the deterioration in the U.S. trade deficit. The latest trade figures confirm the leveling off of our trade deficit during the course of last year. We expect the deficit will decline from \$148 billion last year to the \$130 billion range this year.

As you know, we have maintained for some time that exchange rates should not be relied upon as the sole means of correcting trade imbalances. Improved growth in our major trading partners is also needed to complement exchange rate changes. At the Paris meeting, the surplus countries committed themselves to strengthening their growth prospects, while the deficit countries agreed to reduce their domestic imbalances.

At the same time, there was broad recognition at the Paris meeting that further substantial exchange shifts could damage growth and adjustment prospects. Such appreciation of the currencies of the other major industrial countries could lead to an economic slowdown or recession that could damage the export markets that are the key to correcting our trade deficit. In the United States, there is also the danger that inflation could increase and interest rates rise, should the dollar depreciate sharply. In these circumstances, therefore, we agreed to cooperate closely to foster stability of exchange rates around current levels.

The experience of recent years demonstrates that governments must retain flexibility in dealing with exchange market pressures. Efforts to establish rigid exchange rate objectives or to specify too precisely the goals of intervention would lead inevitably to speculative capital flows that would overwhelm the government's ability to react effectively. While there are clear understandings among the major countries regarding cooperation, we have refrained from establishing a system of target zones or ranges and have not spelled out the manner in which we intend to deal with possible market developments. For the same reasons, I believe, that to mandate establishment of a specific exchange rate objective and the intervention to achieve that objective would be counterproductive and result in the very instability that we all seek to avoid.

Discussions are proceeding on additional refinements to provide greater discipline and simplicity to the indicator mechanism. We anticipate that the report on progress made in implementing the Tokyo arrangements will be made to the heads of state and government at their Economic Summit meeting in Venice in June. We believe these to be the appropriate next steps in improving our arrangements for international cooperation on financial and economic matters among the major industrial nations, and it would be premature to consider either new approaches or fora.

Responsibility for actions contributing to the adjustment of external imbalances does not rest with the major industrial countries alone. Some of the newly industrialized countries in Asia are now ready to be brought into the world trading system as full-fledged participants. How they should meet their responsibilities will vary from country to country, but one essential element will be that they follow policies that allow their currencies to better reflect economic fundamentals.

DEBT STRATEGY

Turning briefly to the debt strategy, the focus here is on the fundamental need for stronger, sustained growth in the debtor nations as a prerequisite to solving their debt problems. The framework itself continues to provide the approach to the debt problem most widely accepted by both debtors and creditors. And substantial progress is already being made.

Leadership in the debtor nations is increasingly focusing on the importance of the market-led growth and adopting reforms necessary to achieve it.

The IMF and World Bank have provided strong support for the debtors' efforts since October 1985, by committing nearly \$12 billion in new loans to the 15 major debtors. Official creditors have also rescheduled \$14.5 billion in outstanding loans to these countries through the Paris Club, providing important debt relief and opening new sources of relief from creditor countries.

In terms of overall financial flows linked to policy reforms in debtor countries, supportive financing or specific Paris Club and commercial bank debt relief has been provided for all of the 15 major debtors, with the single exception of Peru since October 1985.

In the past few weeks, the banks have also begun to move ahead on the backlog of new financing packages, including formal signature of the Mexican financing package, agreements with Chile and Venezuela and the resumption of negotiations with the Philippines. These agreements, together with others for Argentina and, we hope, for Brazil, will also assure substantial new commercial bank lending to the major debtor nations in 1987.

Are additional measures needed for debt strategy? That is a question that is being widely asked. I think more can be done, but in developing additional steps, we must avoid the temptation of the quick fix, overnight solutions which would offer marvelous short-term relief at the expense of both sustained growth and continued access to financial markets.

Treasury has, in fact, already urged the commercial banks to adopt a menu of options for supporting debtor reforms as a means of maintaining broad bank participation in the new financing packages. We believe the banks should be able to provide a range of options which could be offered to participating banks in the syndicate. Or they might simultaneously pursue several different approaches, where permitted under their own regulatory systems, provided the liquidity value of the total transactions to the debtor nations is equivalent to the banks' new money obligation.

The difficulties in devising mechanisms for fairly allocating new money shares with a broad diversity of types of flows should not be underestimated. However, we must face the fact that greater flexibility in devising new money packages may in effect be essential to future bank syndications.

We may also find that both debtor governments and commercial banks with a common interest in limiting the total debt burdens will increasingly be moving toward repricing, retiming, or rescheduling agreements in the future as an alternative to new loans. The benefits of such approaches may be substantial and may, in the right circumstances, be easier to achieve than new money packages.

What about proposals for an IMF or World Bank debt facility? This appears to be one of the most popular ideas on Capitol Hill at present.

Such a facility would be financed, according to these proposals, by various means: contributions from nations with large current account surpluses; member governments of the parent organization could be asked to provide paid-in or callable capital; or IMF gold assets could be used as a basis against which to borrow substantial sums in the market; or commercial banks could receive bonds from the facility in return for their debt paper.

These proposals suffer from a number of common problems. Public budget and revenue costs could be extremely large. Any contributions by current account surplus countries would only be forthcoming if other major industrial countries, including the United States, contributed as well.

U.S. bank losses on their sale of debt paper would be tax deductible; such deductions could run into several billion dollars. The full risk on commercial bank debt portfolios would also be assumed by the facility, backed in turn by member nations' taxpayers.

DEBT FORGIVENESS PROPOSALS

As with debt forgiveness proposals, banks which have taken a substantial loss would be unlikely to provide new loans for years to come. If the facility is closely linked with the World Bank, the bank's credit rating would be adversely affected, in turn increasing the cost of World Bank loans to all its borrowers.

Furthermore, such proposals would provide little effective relief for the debtor countries. Without adequate policy reforms, any short-term boost to growth or imports could not be sustained. And such short-term benefits would be very limited. Even if the new facility were able to purchase, for example, the full \$283 billion in outstanding bank debt of the 15 major debtors at, let us say, a 35 percent discount, they would save only \$6 billion in interest payments annually.

Debt equity swaps have provided significant relief of debt and debt service burdens, while also supporting new investment flows and repatriation of flight capital. Further development of such swaps as well as broad mutual funds for conversion into equity, hold significant potential for both reducing debt burdens and improving debtor prospects for growth. In my view, these provide a preferable route to debt relief for the debtor nations.

Thank you very much, Mr. Chairman.

[The complete prepared statement of David C. Mulford follows:]

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STATEMENT OF THE HONORABLE
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BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND MONETARY POLICY
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
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Mr. Chairman, Members of the Subcommittee:

I welcome this opportunity to discuss our efforts to reduce the U.S. trade deficit, improve the operation of the international monetary system, and deal with the international debt problem.

The Administration's approach to reducing our trade deficit is now embodied in our proposals to improve the ability of the United States to compete in the world economy, for which legislative language was submitted February 19. The six elements in the competitiveness package concern increasing investment in human and intellectual capital; promoting the development of science and technology; better protecting intellectual property; enacting essential legal and regulatory reforms; reducing the budget deficit; and shaping the international economic environment. It is this last element that is most relevant to my appearance before your Subcommittee today.

Our approach to shaping the international economic environment has been designed in large part to respond to the three broad causes of the deterioration in our trading accounts in the 1980s: the strength of the dollar, U.S. economic performance relative to that of the other major industrial countries, and the LDC debt situation. Thus, while pursuing an aggressive, comprehensive trade policy, we have focused a great deal of time and attention on (1) strengthening international economic cooperation among the industrial nations to achieve exchange rates

in line with economic fundamentals and to promote balanced growth, and on (ii) developing and implementing a strategy to deal with the problems of the heavily indebted developing countries.

International Economic Cooperation

The Plaza Agreement of September 1985 marked a major turning point in our efforts to achieve closer international economic cooperation. Not only did it reveal agreement among the five participating nations on the need for adjustment of the dollar exchange rate, it also broke ground in developing a consensus on adjustments in national policies needed to achieve improved, more balanced growth and the reduction in external imbalances necessary for improved exchange market stability.

Building on the Plaza Agreement, the leaders of the Free World's major democracies meeting in Tokyo last May agreed on a framework for closer coordination of economic policies among their countries, using a range of economic indicators. The February 22 meeting in Paris of Finance Ministers and Central Bank Governors of a number of major industrial nations carried this process forward by agreeing on concrete steps to promote improved more balanced global growth and smaller trade imbalances. I would like to spend a moment describing the Paris Agreement in order to put the Administration's approach in perspective.

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In the past two years, substantial exchange rate changes have occurred, with the dollar depreciating by 40-50 percent against the currencies of the other major industrial countries. About two-thirds of that shift has taken place since the Plaza Agreement. This exchange rate adjustment has helped to halt the deterioration in the U.S. trade deficit. The latest trade figures confirm the leveling off of our trade deficit during the course of last year. We expect the deficit will decline from \$148 billion last year to the \$130 billion range this year.

As you know, we have maintained for some time that exchange rate changes should not be relied upon as the sole means of correcting trade imbalances. Improved growth in our major trading partners is also needed to complement exchange rate changes. At the Paris meeting, the surplus countries committed themselves to strengthen their growth prospects, while the deficit countries agreed to reduce their domestic imbalances. More specifically, Germany indicated that it plans to proceed with a major tax reform and to increase the size of its tax cuts scheduled for 1988, in addition to the action taken to lower its interest rates. For its part, Japan announced a cut in its discount rate to 2.5 percent and committed itself to prepare a comprehensive economic

program to stimulate domestic demand after its 1987 budget is approved by the Diet.

The United States also has responsibilities. We must press ahead with our efforts to reduce the federal budget deficit. We need to move forward with a wide range of policies to improve the competitiveness of our economy. And we must continue to oppose protectionist pressures.

At the same time, there was broad recognition at the Paris meeting that further substantial exchange rate shifts could damage growth and adjustment prospects. Such appreciation of the currencies of the other major industrial countries could lead to an economic slowdown or recession that could damage the export markets that are the key to correcting our trade deficit. In the United States, there is also the danger that inflation could increase and interest rates rise should the dollar depreciate sharply. In these circumstances, therefore, we agreed to cooperate closely to foster stability of exchange rates around current levels.

The experience of recent years demonstrates that governments must retain flexibility in dealing with exchange market pressures. Efforts to establish rigid exchange rate objectives or to specify too precisely the goals of intervention would lead inevitably to speculative capital flows that would overwhelm the government's ability to react effectively. While there are clear understandings among the major countries regarding cooperation, we have refrained from establishing a system of target zones or ranges and have not spelled out the manner in which we intend to deal with possible market developments. For the same reasons, I believe that to mandate establishment of a specific exchange rate objective and intervention to achieve that objective would be counterproductive and result in the very instability that we all seek to avoid.

The Paris meeting represents a step forward in our economic policy coordination efforts. There is, however, further scope to improve the process. Discussions are proceeding on additional refinements to provide greater discipline and simplicity to the indicator mechanism. We anticipate that a report on progress made in implementing the Tokyo arrangements will be made to the Heads of State and Government at their Economic Summit meeting in Venice in June. We believe these to be the appropriate next steps in improving our arrangements for international cooperation on financial and economic matters among the major industrial nations and that it would be premature to consider either new approaches or fora.

Responsibility for actions contributing to the adjustment of external imbalances does not rest with the major industrial countries alone. Attention has also been brought to bear on the responsibilities of some of the newly industrialized countries in Asia. These NICs owe much of their development to open markets.

They are now ready to be brought into the world trading system as full-fledged participants. How they should meet their responsibilities will vary from country to country. But one essential element will be that they follow policies that allow their currencies to better reflect economic fundamentals. As these countries run current account surpluses, there should be a natural tendency for their currencies to appreciate.

The Debt Strategy: Progress and Prognosis

The current international debt strategy focuses on the fundamental need for stronger, sustained growth in the debtor nations as a prerequisite to solving their debt problems. That objective has universal support among debtors and creditors alike.

The development and implementation of growth-oriented policy reforms by the debtor nations themselves, including both macro-economic and structural elements, are essential to achieving that objective. So are supportive international capital flows: new lending from the IMF, the World Bank, and the private commercial banks; new foreign direct and portfolio investment flows; and the repatriation of flight capital.

At the present time, we are in a period of rather intensive questioning about whether or not the debt strategy is working. We have heard these concerns before, usually, as is the case now, when there is a concentration of debtor country financing activity which seems to underline the enormity of the global problem.

Given the fact that the debt strategy provides a dynamic framework for policy reforms, assembling resources, and resolving country problems on a case-by-case basis, I believe this focus of attention is essentially healthy. By constant review within the case-by-case framework, new ideas and refinements can be developed and implemented. Indeed, this is what has been happening over the past 18 months.

The important point here is that the framework itself continues to provide the most widely accepted approach to the debt problem by both debtors and creditors. No workable and widely accepted alternative has been put on the table, and it is therefore on the basis of present reality that we must assess our progress.

Perhaps the most important change during the past year and a half has been in debtor attitudes. The debtor nations are increasingly focusing on the importance of market-led growth, and adopting the reforms necessary to achieve it. These include steps to increase savings and investment, improve economic efficiency, privatize public enterprises, liberalize trade and investment regimes, and reform tax and financial systems. A great deal more needs to be done, but there is general movement in the right direction in many debtor countries.

The real growth rate for the 15 major debtors as a group is expected to average approximately 3.5 percent this year, the highest since 1980, and a significant improvement over 1983, when the major debtors experienced negative growth of 3.5 percent. Import volumes are also projected to increase by more than 3 percent this year, the best performance in 6 years, while export volumes should grow by about 3 percent, the best in 3 years.

Despite recent oil and other commodity price declines, GNP growth in most of the major debtors has kept pace with or exceeded the growth in total debt. The ratio of interest payments to exports, which is key because it measures the capacity to service debt, has also improved substantially, with a projected ratio of 25 percent for the 15 major debtors this year, compared to 31 percent in 1982.

The IMF and World Bank have provided strong support for the debtors' efforts since October 1985 by committing nearly \$12 billion in new loans to the 15 major debtors. In this same period, official creditors have also rescheduled \$14.5 billion in outstanding loans to these countries through the Paris Club, providing important debt relief and opening new sources of financing from creditor countries.

Progress on the third leg of the strategy -- commercial bank lending -- has been slower to develop and by the end of 1986 was clearly inadequate. To some extent, this is due to the process involved: under concerted lending procedures, commercial bank loans only come into play after debtor reform programs have been developed and have in most cases received IMF and World Bank support. This takes time, and should not have been expected to produce a large increase in bank lending within the first few months of 1986. Nor would one expect net flows to be distributed evenly over time, since sizable new loans are linked to policy negotiations. In addition, some major debtors such as Brazil and Venezuela did not need new loans in 1986.

In terms of overall financial flows linked to policy reforms in debtor countries, there have been a number of important developments in the past 18 months. These include supportive financing or specific Paris Club and commercial bank debt relief for all of the 15 major debtors, with the exception of Peru, since October 1985. Reschedulings by commercial banks, over and above the \$14.5 billion of Paris Club reschedulings, have provided longer maturities at lower rates and spreads on an additional \$70 billion of outstanding debt.

In the past few weeks, the banks have begun to move ahead on the backlog of new financing packages. Formal signature of the Mexican financing package is now underway. Chile has reached agreement on a package which includes retiming and repricing arrangements. Venezuela and the banks have agreed on a rescheduling of principal payments due on previously rescheduled debt at lower spreads. The Philippine negotiations resumed in

early March. Progress in these discussions will help to dispel concerns of a new debt crisis, which is in the interest of debtors and creditors alike. These agreements, together with others for Argentina and we hope Brazil, will also assure substantial net new commercial bank lending to the major debtor nations in 1987.

Additional Measures?

I believe this is a picture which represents significant progress. No one ever said that the negotiations, whether for policy change, new money, or rescheduling, would be easy. There will continue to be difficult problems and periods of significant risk, but we have built an important experience base where cooperation between debtors and creditors has been the rule.

Are additional measures needed? I think more can be done, but in developing additional steps, we must avoid the temptation of quick-fix, overnight solutions which would offer modest short-term relief at the expense of both sustained growth through needed policy reforms and continued access to financial markets.

Treasury has, in fact, already urged the commercial banks to develop a "menu" of options for supporting debtor reforms as a means of maintaining broad bank participation in new financing packages. We believe the banks should be able to provide a range of options which could be offered to participating banks in the syndicate. Or they might simultaneously pursue several different approaches, where permitted under their own regulatory systems, provided the liquidity value of the total transactions to the debtor nations is equivalent to the banks' new money obligation.

The difficulties in devising mechanisms for fairly allocating new money shares with a broad diversity of types of flows shouldn't be underestimated. However, we must face the fact that greater flexibility in devising new money packages may, in effect, be essential to future bank syndications. Indeed, a case by case approach demands a willingness to develop and try new techniques as well as adjusting them to recognize performance. Instead of merely complaining that there is no leeway in current procedures, or that the IMF simply imposes new money requirements on the banks, the commercial banks have much to gain from taking the lead themselves to develop the kinds of ideas that help assure the concerted lending process works.

We may also find that both debtor governments and commercial banks -- with a common interest in limiting total debt burdens -- will increasingly be moving toward repricing, retiming or rescheduling agreements in the future as an alternative to new loans. The benefits of such approaches may be substantial and may, in the right circumstances, be easier to achieve than new money packages. For debtors with substantial financing needs, however, new lending will still be necessary and should be expedited by debtors and commercial banks alike.

Debt Facility

What about proposals for an IMF or World Bank debt facility? This appears to be one of the most popular ideas on Capitol Hill at present.

Such a facility would be financed, according to these proposals, by various means: contributions from nations with large current account surpluses (a polite way of saying Germany and Japan); member governments of the parent organization could be asked to provide paid-in or callable capital or IMF gold assets could be used as a basis against which to borrow substantial sums in the market; or commercial banks could receive bonds from the facility in return for their debt paper.

These proposals suffer from a number of common problems:

Public budget and revenue costs could be extremely large. Any contributions by current account surplus countries would only be forthcoming if other major industrial countries, including the United States, contributed as well. To leverage sufficient financing to purchase commercial banks' outstanding debt, substantial paid-in or callable capital would be required. U.S. bank losses on their sale of debt paper would be tax deductible; such deductions could run into several billion dollars. The full risk on commercial bank debt portfolios would also be assumed by the facility -- backed in turn by member nations' taxpayers.

As with debt forgiveness proposals, banks which have taken a substantial loss would be unlikely to provide new loans for years to come. If the facility is closely linked with the World Bank, the Bank's credit rating would be adversely affected, in turn increasing the cost of World Bank loans to all borrowers. Debtor nations might well welcome the debt relief offered by the facility as an excuse to avoid needed policy reforms. Without such reforms, any immediate benefits to their liquidity would be short-lived and any boost to debtor growth and imports could not be sustained.

Furthermore, such a proposal would provide little effective relief for the debtor countries. Without adequate policy reforms, any short-term boost to growth or imports could not be sustained. And such short-term benefits would be very limited. Even if the new facility were able to purchase the full \$283 billion in outstanding bank debt of the 15 major debtors at a 35 percent discount, they would save only \$6 billion in interest payments annually. By way of comparison, reductions in market interest rates since the end of 1984 have already provided over \$14 billion in annual debt service savings, while reschedulings and reductions in commercial bank spreads have provided substantial additional "debt relief", without the adverse repercussions of a debt facility.

Debt equity swaps, which totalled nearly \$2.5 billion last year in four debtor nations alone, have also provided significant relief of debt and debt service burdens, while also supporting new investment flows and the repatriation of flight capital. Further development of such swaps, as well as broader mutual funds for conversion into equity, hold significant potential for both reducing debt burdens and improving debtor prospects for growth. In my view, these provide a preferable route to "debt relief" for the debtor nations.

In short, there are no real "overnight solutions" to debt difficulties. Progress will take time, must be founded on economic reforms, and buttressed by enough new financing to meet the debtors' immediate needs to support reform and to generate growth. That is the essence of the strengthened debt strategy -- a process that is now being implemented, and that has the support of debtors and creditors alike. Our task is to get on with this program and to assure its success.

Conclusion

This Administration has developed a comprehensive strategy for correcting our trade deficit. Implementation of some elements is well advanced; we are moving ahead in other directions with the President's new competitiveness initiative. The Administration is working with the Congress on legislation in this area. We believe we have reached the turning point in our efforts to reduce the trade deficit. But it remains large, and we cannot relax.

Senator SARBANES. Thank you, Mr. Secretary.

Mr. Secretary, what is the rationale for seeking to stabilize the dollar/yen exchange rate at 150 per dollar?

Mr. MULFORD. At the time of the Paris meeting where the Ministers and Governors indicated that they intended to cooperate to stabilize the exchange rates around current levels, the rationale was based on a couple of important propositions.

One is the adjustment process that has to be accomplished, and the removal or reduction of the large external imbalances we have today in the world, cannot be accomplished solely by exchange rate changes.

Second, another important aspect was the fact that, as you know, we are encouraging our major trading partners to increase domestic-led growth in their economies and to structure their economies so they become, over time, less dependent on exports and more dependent upon long-term domestic-based growth.

Senator SARBANES. Under the understanding, when will that happen?

Mr. MULFORD. It has been happening. There has been a process of adjustment going on.

OUR TRADE DEFICIT DECLINES

In the first instance, as I said in my statement, we believe that we have stopped the rise of our trade deficit and current account deficit. That is clear in the 1986 figures, where there is a clear leveling off, and now we expect some additional improvements during the course of 1987.

The full effects of exchange rate changes——

Senator SARBANES. No. When do you expect the growth to take place, for instance, in Germany and Japan?

Mr. MULFORD. Well, both countries have undertaken at the Paris meeting, for example, to initiate measures that would have the effect of improving domestic growth.

Senator SARBANES. I understand that. When is it supposed to happen?

Mr. MULFORD. In the case of Germany, they are engaged at this time in a major tax reform, for example, which will involve in the first instance an increase in tax cuts that are planned for January 1988.

Senator SARBANES. January when?

Mr. MULFORD. January 1988.

Those are already legislated. They have committed to increase the size of those cuts and also to carry out a major tax reform which they hope to have fully implemented by 1990.

Senator SARBANES. By 1990?

Mr. MULFORD. By 1990.

In Japan they have committed to provide a package of measures after the passage of their budget, which is currently under consideration in the diet, to be implemented shortly thereafter.

We do not yet know when the measures will be passed. It may well be by April 1, but it may well be by the end of April instead, and after that we expect to see measures announced by the Japanese Government to stimulate their economy.

Senator SARBANES. I am interested in how you make your calculations at the bottom of page 7 of your statement.

Accepting your assumptions now, some of which I think might be very optimistic, how do you calculate the interest payment savings which would result for the debtor countries under an international facility purchase of outstanding bank debt?

The sentence that says, "Even if the new facility were able to purchase the full \$283 billion in outstanding bank debt of the 15 major debtors at a 35 percent discount rate, you would save only \$6 billion in interest payments annually."

Mr. MULFORD. Yes. That is meant to be an example.

Senator SARBANES. Yes, but I want to find out how you make that calculation.

Mr. MULFORD. First of all, you take the \$283 billion of debt and assume that it has been purchased by a facility at a 35 percent discount. You then assume that there will be a forgiveness of the debt equivalent to the discount that has been accomplished in that transaction.

Senator SARBANES. Which would be 35 percent of \$283 billion, is that correct?

Mr. MULFORD. If that was what was provided afterward as debt relief, yes.

Senator SARBANES. That would be \$100 billion, right?

Mr. MULFORD. I can't work that out just looking at it. It would be, I guess, about that.

Senator SARBANES. Then you figure if you have forgiveness on \$100 billion your interest savings would be \$6 billion, is that correct?

Mr. MULFORD. Yes.

Senator SARBANES. These countries are paying at that rate on their debt?

Mr. MULFORD. The London interbank rate is around that level. They are paying somewhat higher rates than that at the moment. The point is here that whether the figure is \$6 or \$7 billion—

Senator SARBANES. It is your figure. I am not trying to make a big policy issue. I am just trying to understand how you have done your calculations. You have got some very specific figures here. You are trying to make a point. I just want to follow.

I want to know what the assumptions are and how it is calculated.

Mr. MULFORD. Let me try to explain that to you. If you take the \$283 billion—

Senator SARBANES. \$283 billion?

Mr. MULFORD. Yes \$283 billion. I cannot off the top of my head give you a breakdown of the composition of that number in terms of different currencies, but it is comprised not just of dollars but a variety of other currencies, Swiss francs for example, deutsch marks, and so on. If you take 35 percent of that number, you will come out with something like \$100 billion.

We have taken a 6 percent interest rate on \$100 billion as a rate that we think appropriately represents the blended rates that would apply to those various currencies.

As you know, deutsch mark and Swiss franc rates are both substantially below dollar rates. Dollar rates are above 6 percent, and

I would guess, although I don't have the calculations in front of me, that we came up with an average rate assumption of about 6 percent on that \$100 billion.

The purpose of that is to show that if the savings was \$6 billion and is not a great deal of money when compared, for example, to the \$14 billion of reduced debt service burdens these 15 major debtors are now enjoying on an annual basis as a result of a 5 percent decline in interest rates over the past 2 years.

Senator SARBANES. Did you make any assumption about what would happen in terms of the terms and rates of the remaining debt if it was handled by an international facility?

Mr. MULFORD. We did not for the purpose of this example.

Senator SARBANES. Conceivably, there could be some savings that would result from that, could there not?

Mr. MULFORD. With the balance of the debt? Certainly. If part of the balance of the debt, for example, ultimately was swapped in that debt equity arrangement, there could be a further saving.

Senator SARBANES. Even if the facility were to be able to provide better terms and rates than existed under outstanding commercial loans, it would have brought some benefit to the debtor countries, would it not?

Mr. MULFORD. I would like to point out that the discount of 35 percent, if that is passed through the debtor countries, already represents very substantial debt relief. That is a very important point because if they purchased that debt at a discount and they do not provide debt relief to the debtors, the debtors still have to pay the interest.

Senator SARBANES. They obviously will pass it through, and they will get some relief there.

The only point I am trying to make is that the debtor country could get some additional help because the facility on the remaining outstanding debt of the country could give them better terms and rates than under existing commercial loans.

Is not that a possibility as well?

Mr. MULFORD. In my view, the key issue is not whether that is a possibility or not but whether the countries are going to carry out the kinds of reforms to justify being given any relief in the first place.

Senator SARBANES. That is the next question I wanted to go to.

Why do you assume that the facility could not link the relief or assistance it provides to reforms in economic policy?

I take it that is your assumption in the previous paragraph.

Mr. MULFORD. I make that assumption because so far I have not seen any credible plan presented by anyone which lays out the kind of reforms that would be negotiated by this facility with the countries, how they would be negotiated, how they would be implemented and, most importantly, how they would be monitored over a period of time.

DIFFICULTIES WITH WORLD BANK LOANS

We already see the difficulties in that business with World Bank loans, IMF programs, and so on, and it doesn't strike me as very credible to talk about accomplishing reforms in these countries if

you are giving all the relief upfront and hoping they will make some reforms later. That is not the way reform takes place in this business.

Senator SARBANES. It is a little bit like the settlement on exchange rates, isn't it? I mean, it is taking place now, and the growth policies that you are talking about in the case of Germany are a year away and further ones two years away and in the case of Japan indefinite?

Mr. MULFORD. I didn't finish my previous comment there, and if I may, I will just take one last second on that. There is growth in Germany and Japan today.

One of our concerns is that that growth should not be killed off by excessive exchange rate movement, and that is clearly a risk. If exchange rates move too far too fast, you will in fact reduce the chances of their maintaining, let alone increasing their domestic growth.

I think that is the other part of the judgment that has to be made.

Senator SARBANES. Senator Heinz. My time is up.

Senator HEINZ. Thank you, Mr. Chairman.

I have got one question I would like to ask you on the newly industrializing countries' exchange rates. Then I want to spend most of the time on the international debt issues.

I have the impression with respect to Korea and Taiwan that their exchange rate policy, while not unimportant to us, is not the most important bilateral economic issue between Korea, Taiwan, and the United States.

I know that many American officials are properly concerned about market access issues, copyrights, and other matters. They are important. But how does exchange rate reform in those two countries fit into our strategy towards those countries?

Mr. MULFORD. I think it is probably wise to look at the exchange rate question in a macroeconomic format and not too narrowly.

But in the case, for example, of Taiwan and Korea, I think it is important that both of those countries should be opening up their markets more, not only to foreign products but they should be introducing more market-oriented practices domestically. They should be restructuring in the same way that we encouraged Japan to restructure, so that they are not so dependent upon exports and they would become more dependent on domestic-led growth.

Senator HEINZ. Our encouragement so far has had a modest result, wouldn't you say?

Mr. MULFORD. That is true. It has had modest results, and a part of this, of course, is exchange rate policies.

We are, as you know, very interested in seeing both these countries follow an exchange rate policy that would better represent their role as major trading nations.

Senator HEINZ. All I am really asking, David, is how much weight do you give their exchange rate policies, Korea and Taiwan, in our bilateral negotiations with them?

Mr. MULFORD. I think it is hard to put a quantity on that, but I think it has to be an increasing weight over time because as their surpluses have grown, and because they fail to recognize this in

their exchange rate policies it becomes a more and more serious problem.

Senator HEINZ. I agree with you. I hope we will not lessen our efforts to achieve market access and to stop the theft of intellectual property, but at the same time let me encourage you to do what you said you want to do, which is to give increased weight to the establishment of real exchange rate reforms by those two countries.

THREE CATEGORIES OF THIRD WORLD DEBT

I don't want to run out of time—so let me go to the issue of third world or developing country debt. We have three categories in which those countries end up—nonclassified, other transfer risk problems, and value impaired—the bargain basement being the latter category for real write-offs.

Those categories were established by the Heinz-Proxmire legislation, the International Lending Supervision Act in, I guess, 1983. As I look at what has happened since then, I have become rather concerned and dissatisfied with the intent of the legislation and the way it is working in practice.

The intent of the legislation was to develop regulatory policies that fit the circumstances of countries. I suppose you could say the value impaired category, where you have Zaire and some real basket cases and the banks basically have to write off those loans on their books, that is all right. That seems to work, although I think there are some ways we could advance our thinking about that a little further.

But I am concerned that we have a lack of differentiation in the other transfer risk problems category. There are countries that are clearly struggling and where the prospects of their doing much at all are very limited, perhaps nonexistent. They are being treated and lumped in with countries that, with a little encouragement and a better set of policies, could well be able to climb out of this debt spiral which they seem to get in that landed them in this category.

At the same time, the poorer performers in this category take on the protective coloration of the better people, and we don't ask our banks to do anything about that. We are afraid if we ask the banks to reserve against them, the banks will say, well, we are just going to pull out and not do anything.

Let me ask you this. Would you accept a distinction between the fact that in the OTRP category there are better performers and poorer performers? Second, if you do, why shouldn't we encourage banks who have loans from the poor performers not to do additional reserving of the conventional kind but to have somewhat higher general capital requirements in order to protect those banks against what might happen in those poor performing countries, which is they might simply not be able to make good?

Mr. MULFORD. That is a very complicated question, and I would like before trying to answer it briefly to just say that, as you know, the regulatory side is quite separated from us and they, I think, are really the ones to properly address those questions for the kind of answers that you are looking for.

But I would certainly be willing to admit that there is a differentiation of countries within a category as to how they are performing. I think that is true.

I would also say that I think that the system has worked reasonably well. I think that one has to remember that the accountants who are outside the system are often giving the banks advice to do one thing or another that may be more or less than that suggested by the regulators.

So some of the finer distinctions that you are seeking I think may well be implemented by the banks in some cases under advice from their private accountants.

Senator HEINZ. What I am proposing is a little bit more caution against a rainy day on poor performers and, although I didn't state it, some additional flexibility and encouragement to be more flexible and creative with the better performers in the OTRP category.

And you yourself mentioned that it would be desirable to encourage more in the way of debt equity swaps.

Is it not the case that with respect to debt equity swaps it is mainly only smaller banks in this country that engage in them and that there are regulatory and accounting practices that cause the larger banks to hold back in this country from undertaking such swaps?

Mr. MULFORD. It isn't true that only small banks participate.

Senator HEINZ. I should have said "largely."

Mr. MULFORD. In many cases large banks are participating as well.

DEBT EQUITY SWAPS

We have looked at the regulations, and we see no fundamental impediment to debt equity swaps, but it is also true that there is a rather fine line when it comes to an increasing level of debt equity swap activity that too concretely defines the value of certain countries' paper on the market, and then there is the possibility that regulators might say, well, these transactions at a discount of 30 percent have to be reflected in the balance of the portfolio.

That is the fear that the large banks have had, but we have not seen that concern really be a major impediment to debt equity swaps.

I would think a more important impediment is the lack of opportunities created by the countries themselves so far. I think if they made further efforts to open toward investment you would see a growth of debt equity swap business.

Senator HEINZ. How do you explain the fact that under the Baker plans new loans are made to countries rated as impaired with no presumption of lost value?

Mr. MULFORD. Rated as impaired?

Senator HEINZ. Yes.

Mr. MULFORD. In all the categories there is the assumption, especially at the upper levels, that the debt is going to be repaid. I think that if in certain circumstances a bank takes a write-off or makes a sale of paper at a discount that is not reason for the bank to stop participating in new money packages because they believe in some way the country isn't capable of ultimately making the

payments. Write-offs from time to time may be an appropriate policy and may in fact increase the health of the debtor as well as of the bank.

Senator HEINZ. My time has expired. Thank you.

Senator SARBANES. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

WHAT IS EXCESSIVE EXCHANGE RATE MOVEMENT

Secretary Mulford, you talk about trying to prevent excessive exchange rate movement, and I certainly think that is a desirable goal. But how do you know what is excessive?

Mr. MULFORD. It depends, I think, what you have in mind by the use of the word "excessive."

Senator GRAMM. You used it. You define it and then tell me how you know what it is.

Mr. MULFORD. I did not have in mind short-term volatility when I was talking earlier about excessive exchange rate movements. I had in mind the idea that if you follow what has happened to exchange rates since the Plaza meeting, for example, you will see there has been a very substantial adjustment over a relatively short period of time.

Second, you will see that the results of those exchange rate movements on deficits and surpluses around the world have not been fully felt yet.

Third, you will see that as the exchange rate adjustment moves it has to be accompanied, in our view, by efforts on the part of, in this case, our major trading partners to increase domestic trading activity.

In other words, we never look exclusively for exchange rates to accomplish the adjustment of an external imbalance. If it is required, we want that partially effected by improvements in relative growth rates so we can see some light down the road for resolving our large trade deficit.

If exchange rates are perceived to have moved so fast and so far that they are negatively impinging upon the ability of our trading partners to maintain or to produce stronger domestic growth, then I think that would suggest exchange rate movement for the time being ought, perhaps, to be stabilized so that the efforts being made to accomplish policy changes can be carried out. How to exactly identify excessive in numerical terms is, of course, a matter of judgment.

Senator GRAMM. I guess the concern I have is that I remember back in the early debate over a farm program the objective there was to eliminate these random shifts and radical swings in prices, and we now have a \$40 billion plus farm program where government is the generator of 50 percent of all the cash income in agriculture.

I guess the concern I have is that if a person is speculating on the international currency market, if they are wrong they ultimately go broke. You cannot be a destabilizing speculator and make money in the long run.

On the other hand, I have grave concerns about using the taxpayers' money to try to intervene in these markets. I guess the

problem we run into is that if we knew what these relative mixes were in terms of exchange rates, if we could institute a policy to try to coordinate the decline in the value of the dollar with efforts by the Japanese and the Germans to stimulate their domestic economy, to shift themselves away from "export-oriented" economies to more domestic consumption economies, then I might have some hope, at least in terms of my assessment for your policy.

I am just afraid that that is not a terribly workable policy, and as I look at the world currency market, I have to come back to the basic conclusion that despite the fact that given some kind of perfect knowledge, given some kind of certainty of action by our trading partners, that you might be able to coordinate this effort and prevent exchange rates from moving further than they have to in order to bring the system back into balance is just not going to be possible.

I am afraid that our intervention will ultimately be destabilizing and, worse than that, as you know, we have massive protectionist forces at work in the country and the Congress that are determined to try to stop trade, not to eliminate unfair trade.

I remember when we were debating the textile bill. It was a long afternoon, and I counted 21 members of the Senate, Democrats and Republicans, who stood up and said we want fair trade, we are not protectionists, we hate protectionism, we want fair trade.

So I introduced what I meanly called my Protectionist Smoke-Out amendment, which said if any nation is less protectionist than we are we will exempt them from the textile bill.

Needless to say, those who were for the bill were not for that amendment because the truth is they don't want fair trade. They want to reduce trade to benefit special interests at the public's expense.

MANIPULATE EXCHANGE RATES

My concern is that if we get heavily into the business of trying to manipulate exchange rates to give our trading partners an opportunity to cushion their development, that we are going to feed these forces of protectionism and the nation is going to be worse off in the long run.

Do you share any of these concerns?

Mr. MULFORD. Certainly, I do share some of those concerns. I think perhaps you are giving a too prominent position to exchange rates, at least as you presented your thoughts there.

I would say that exchange rates must in some way reflect the underlying economic fundamentals. If the underlying economic fundamentals can be brought together in a way that establishes a reasonable pattern of growth around the world, the probability is that more stable exchange rates will follow without intervention, and we are working towards that kind of goal.

We made the judgment, when we were in Paris that present exchange rate levels do represent underlying economic fundamentals after the period of adjustment. That is obviously a question of judgment, but it is nevertheless a judgment that we made for reasons I have already explained.

The aim here is to see if there can't be a period of reasonable stability instead of excess volatility or variability so that the adjustment process that we are looking for is given a little time to work.

I can give you one example that would, perhaps, illustrate what I mean. In the case of Germany, where there has been less good growth recently than had been the case even a few months ago, one of the arguments used is that approximately 50 percent of the German economy is impacted by things, international exchange rates included. Therefore, if exchange rate adjustment is too fast and excessive, it affects investment decisionmakers in that country, for example, who are making international investment decisions but also domestic investment decisions, and the argument runs that you can't effectively stimulate the domestic sector of an economy if you have undermined the willingness of those investors to invest by excessive exchange rate adjustments.

So there is a delicate balance that has to be established here, and one has to at least give our trading partners a chance to carry out the kind of reforms that will produce higher domestic growth, and I think that is the period we are in now. We are waiting and watching to see what sort of performance materializes, not over the period from here to 1990 but in the next few months, and see whether we get the kind of potential growth results in Germany and Japan that appeared to be justified when we made the judgment in Paris.

Senator GRAMM. Let me just get your reaction, assuming I am running out of time. I think one of the problems I see with this approach is that it implicitly assumes that once these internal adjustments have occurred then those adjustments are going to tend to push exchange rates in terms of the value of the dollar, for example, above the level they might drop to without this discussed intervention.

Look at Japan, for example. As I view it, we have a trade deficit with Japan that has very little to do with competitiveness. In fact, a nation cannot become noncompetitive because you can't buy something unless ultimately people have something you want in exchange.

We have a big trade deficit with Japan because we have a huge capital inflow, and that demand for American dollars in yen has driven up the value of the dollar, made American exports less attractive, Japanese imports more attractive.

If you stimulate the Japanese economy, make them more domestic production oriented and more consumption oriented, are you going to lower their thrift rate, or are you going to generate more excess savings, which will spill into the American economy, and you lower the value of the dollar, and you make the exchange rate move further than the level you are trying to institute it now.

Isn't it possible that if your policy is successful it is going to lower the value of the dollar, not raise it, unless I am mistaken on this, but I don't think so.

Mr. MULFORD. I think you are assuming two things. One is that as the Japanese increase their domestic growth through the measures that you mentioned they do not import any more from us, but

I believe they would and they would import more from other parts of the world if they had effectively restructured their economy.

Second, if they were willing to continue—and I think they are willing to make continued efforts—to carry out further major reforms of their domestic capital market so that Japanese savers are presented with more attractive opportunities for investment in Japan, I don't think the capital flow pattern that you suggested needs to be a constant feature of the future.

So what I am saying is, for example, in Japan, after all of the efforts we have made, we estimate they still have only deregulated about 20 percent of their deposit market. If they were to introduce liberalizations and deregulation to a greater extent in their domestic capital market, I don't think you would see the same kind of outflows on the part of private Japanese investors which you see today. I think they would be more attractive to stay home, and if there were stronger domestic growth there would be a greater reason for them to stay home and invest in the domestic economy.

Senator GRAMM. Just to conclude my comments, the point is, however, that if you get down to the bottom line, the thing that is making the exchange rate between the yen and the dollars is a huge flow of Japanese capital into the United States because we are growing faster than they are, our market for equity capital is more attractive but, most importantly, we have the highest real interest rates in the world; we are deficit savers, they are surplus savers, and I don't see, no matter how you cut it, if you induce them to invest more at home, you are going to lower the value of the dollar even though there will be a feedback in the demand for American goods.

I am not saying that is good or bad. I am just saying that the policy of stimulating these economies will help our trade deficit, but it will do it at the expense of the capital flow and it will produce a lower value dollar.

So I have trouble seeing the argument that we don't want the value to go down further because we don't think it represents a long-term equilibrium and that what we want to do is to get them to stimulate their economy. I don't see logically how stimulation of their economy, which is going to have the biggest impact on capital, cannot lower the value of the dollar on the world market.

Senator SARBANES. Did you want to respond to that?

Mr. MULFORD. Of course. I think it is very hard to know exactly what currencies are going to do in the future. That is a very difficult question, but I do think it is a desirable objective for the United States to attempt to get higher growth levels domestically in our major trading partners.

Senator GRAMM. I agree.

Mr. MULFORD. Because that is the way to reduce our external imbalances in the world as they exist today. I think the alternative to that is highly unacceptable, that we should adjust their growth now because they are not growing enough and introduce a recession in our country and, ultimately, in the world, which would also carry out the adjustment that is required.

I think that is a very undesirable option. Finally, another option is to look for that adjustment to be accomplished solely by looking to exchange rates.

I think that is very, very undesirable because it would mean excessive movements in the exchange markets that could be avoided if countries are willing to make the kind of economic policy changes and restructuring that is necessary to produce long-term, higher levels of growth.

And, finally, in this case, another reason for us to look to, Japan and Germany, particularly, to increase their domestic growth is that, in my view, we cannot effectively deal with the debt problem unless there is a reasonable level of growth among the major industrial nations.

REDUCED GROWTH MEANS TROUBLE

If we move in the direction of reduced growth, then we are headed for real trouble in the debt strategy. I think one has to look, therefore, to a sort of a pattern of growth figures being produced around the world that will ultimately restore that relationship that we need, which is higher growth among our major trading partners, that will help us resolve our debt strategy, and with open markets help ease the debt problem by allowing the debtor countries to establish stronger growth rates themselves.

Senator SARBANES. We have a vote on that. In fact, it's in its closing minutes. We'll recess briefly. Senator Graham of Florida was planning to return, and he has some questions to put to you, Mr. Secretary.

I have just a few more before we conclude. We'll take about a 10-minute break for the purposes of the vote. We'll return, conclude with the Secretary, and then go to the panel.

[Recess.]

Senator SARBANES. The committee will resume.

Mr. Secretary, Senator Graham wanted to ask you some questions, but he's been detained. I'm not sure he's going to be able to make it. Let me ask a few that I have as a followup. If he's unable to make it back, we'll excuse you and go on with the panel.

I must say to you that I listened to your testimony with growing concern because it seemed to me there's not the sense of urgency about the situation that I think is warranted.

WORLD'S LARGEST CREDITOR NATION

We've now moved from being the world's largest creditor nation to being the world's largest debtor nation, in really just a handful of years. We continue to run this large trade deficit and even if you say, well, it's going to come in at \$140 billion, that's another \$140 billion that's added on to our debt situation.

A great deal is made out of the growth in Germany and Japan, but I've seen estimates that that would not contribute more than \$5-10 billion as far as the U.S. trade deficit is concerned.

Do you disagree significantly with those estimates?

Mr. MULFORD. It depends what the growth levels are.

Senator SARBANES. I understand that. But, realistic growth rates?

Mr. MULFORD. It is true that short-term growth rates do not reduce substantially the deficits. It is a question that takes a period of time to make the adjustment.

Senator SARBANES. Let me ask you this general question. Do you think that Japan and West Germany are carrying international economic responsibilities commensurate with the strength of their national economies in the world economy?

Mr. MULFORD. I would say that I do not believe they have up until this time.

Senator SARBANES. When you say that, are you also factoring into your thinking the extent to which they contribute to the security umbrella of the free world?

To be more pointed about that, the United States is putting 6.5 percent of GNP into Defense. West Germany is putting what? Three and a half percent. Japan, 1 percent.

Mr. MULFORD. These are questions that lie a little bit outside my area of responsibility, and I would think that I could not give you a very intelligent assessment of that question.

Senator SARBANES. When you press the Japanese to assume more economic responsibilities, is the point made to them that they're not carrying anywhere near a proportionate share of the security responsibility?

I'm not necessarily arguing that they should then be pushed to rearm and become a military power, but it seems to me quite reasonable to press the point that they ought to assume more of the economic responsibilities.

Mr. MULFORD. I know that point has been made on many occasions by the administration, certainly.

Senator SARBANES. How front and center is it?

I'm really pushing for a reappraisal of this relationship. And it's one of the reasons that some of us are interested in this debt facility as a way of getting these large current account surpluses—can make a major contribution toward international growth.

Mr. MULFORD. As I said before, I cannot, myself, comment on those particular questions because, in the discussions that we have had on economic policies, those discussions have been aimed at economic policy considerations in those countries.

They have not broadened out into that other question which you've raised.

Senator SARBANES. So, when you press them for an economic response, you do it within the limited context of the economic dimension without having as part of the dimension the security dimension.

If you do that, it seems to me you're going to press for a lot less than is warranted and justified than if you do it in a broader context.

Is that correct?

Mr. MULFORD. The conversations that we have had have focused on economic policies, that is correct.

Senator SARBANES. What do you expect the trade deficit will be at the end of this year?

Mr. MULFORD. Our estimate, at the moment, is that it would be in the range of about \$130 billion.

Senator SARBANES. What would be your estimate for the following year?

Mr. MULFORD. The following year I think it is likely—again, it depends upon what economic developments we see in these coun-

tries and how much further flowthrough there is of the exchange rate changes that have taken place.

But we would expect to see some further improvement. But I would say that on present projections, if there is not an improvement of the magnitude that I believe to be necessary to make the kind of progress we need to make on reducing external imbalances—in other words, we need more policy actions and I think we need to remember another thing.

And that is that the entire composition of our trade deficit is not entirely based on our relationship with Japan and Germany; it is a much more comprehensive problem than that.

And the discussions that have taken place, for example, in Paris, of the countries who comprise something like half of our trade deficit, the balancing being with the NIC's, the debtor countries, with Canada and so on.

So, in a way, one has to look at other facets of the trade deficit before you can make an estimate as to how much progress you think you can accomplish over the period of a couple of years.

Of course we are also focusing on problems with the NIC's.

Senator SARBANES. I listened to your response to Senator Heinz on that and, again, I was concerned with what I felt was a lack of urgency.

INCREDIBLE TRADE SURPLUS

Take Taiwan, which between 1980 and 1985, built a substantial bilateral trade surplus with the United States. At the same time, the Taiwan dollar fell in value relative to the U.S. dollar, although trade flows were rising in the Taiwan dollar.

In other words, they were able to get it both on the trade side and on the currency side. And the benefit of the interaction between those two.

Actually, they're running, for the amount of trade involved between the 2 countries, they're running an incredible trade surplus, are they not?

Mr. MULFORD. That is correct.

Senator SARBANES. And building up these very huge reserves, as I understand it.

Mr. MULFORD. That is right.

Senator SARBANES. How hard are we pushing them on that? I think you said to Senator Heinz, "well, we've made it sort of part of the talks." But it seems to me I think he asked whether it was the primary or leading part, and you said, "well, no, it was a part of it but it didn't have that degree of importance."

Mr. MULFORD. I did not mean to convey that impression at all. I tried to convey the impression that it was of prime interest to us over and above the other issues that have been discussed with those countries in the trade area.

In other words, that it was an issue that was not going to replace our concern about narrower trade focuses, but would be in addition to those.

But I would like to make it very clear here today that we have placed a high priority—and, in fact, there was a paragraph in the Paris Agreement in which the Ministers and Governors drew at-

tention to the newly-industrialized economies and called upon those countries to follow policies to increase domestic growth, and to allow their currencies to reflect their surplus situation.

We are in discussions with both Korea and Taiwan and up until now, although they have made some effort to appreciate their currencies against the dollar, and they have had some success with that in the past three or four months. We are, at this point, still disappointed in the results.

Senator SARBANES. Let me turn to the debt problem for a moment. The focus I guess with Germany and Japan has been on growth in their own domestic economies.

What about focusing on them to make a contribution, a more significant contribution, since they're considered a large, current account surplus country, to force growth in the developing world and, in particular, to do it multi-laterally rather than bilaterally, because at least it's my perception, when they do it bilaterally, one way or another, they tie to future trade.

And that you need to do it in a multi-lateral context if it's to be free of that tying element.

In some ways, wouldn't that be more helpful to us if the Latin American countries could resume a growth pattern, given past trade patterns?

Wouldn't that be more significant for its impact on the U.S. trade deficit than the impact that would come from growth internally in the Japanese internal economy?

Of course, you don't have to do either or, you can do both of those.

ACROSS-THE-BOARD GROWTH LEVEL NEEDED

Mr. MULFORD. You need both. You need a minimum level of growth in the OECD nations, the industrial nations. And we believe that the average, across-the-board growth level that is needed in the OECD is in the area of 3 percent in order to help resolve the international debt crisis.

It is interesting to note that between 1982 and 1985, the United States took some 60 percent of the increased exports of the major debtor countries, compared, as I remember, to something like 8 percent for Japan and about 15 percent for Europe.

Obviously, if Japan and Europe were more open to the products of the debtor countries than they have been in recent times, that would be of great assistance to the debtor countries as they attempt to reestablish sustained growth in the multilateral format that you mentioned.

I think we should not forget that Japan and Germany do perform their roles in the International Monetary Fund and in the World Bank by way of putting in resources. They have taken the position that there should be a relationship between the amounts they put in and the amounts we put in.

The United States has been more conservative than they have; Japan recently made a special arrangement with the IMF for \$2-3 billion of additional resources.

So I think some of those things are happening.

Senator SARBANES. My time is up.

Finally, on that point, do you still take the view though that what they're doing is well short of what reasonably can be expected they should do given the strength of the national economy and the world economy?

Mr. MULFORD. In the multilateral setting?

Senator SARBANES. Yes, in that setting and more broadly.

Mr. MULFORD. I think the most important thing that they need to do is to continue to make the kinds of economic policy changes and structural changes that enabled them to have stronger sustained domestic growth.

I think that would be the greatest service that they could perform, both for the world economy at large and also for the reduction of external surpluses.

Senator SARBANES. Do you think they're contributing multilaterally at a level that's commensurate with the strength of their national economy in the context of the international economy today?

Mr. MULFORD. That's a hard judgment for me to make off the top of my head.

Senator SARBANES. Because if you don't press them on it, no one will.

Senator Gramm.

Senator GRAMM. Mr. Chairman, I'm just on limited time, so I'll just go to the panel if you're ready.

Senator SARBANES. Sure. Thank you very much, Mr. Secretary. We appreciate your appearance.

If the panel would come forward. Gentlemen, we appreciate your patience. Gentlemen, your full statements will be included in the record as submitted to the committee. If you could each take five to 10 minutes to summarize them, then we'll proceed with questions.

Mr. Kenen, why don't we start with you, and then we'll run right straight across the panel.

STATEMENT OF PETER KENEN, DIRECTOR OF THE INTERNATIONAL FINANCE SECTION, PRINCETON UNIVERSITY

Mr. KENEN. Thank you, Mr. Chairman. My name is Peter Kenen, Professor of Economics at Princeton University, and Director of the International Finance Section there.

Allow me to thank you for the opportunity to testify today. The issues you've chosen to explore, Exchange Rate Policy and Management of International Debt, affect in vital ways the health of the world economy and, therefore, the health of our own economy, which is linked tightly to the world economy in ways we are just starting to appreciate.

That these hearings on exchange rate and debt problems are taking place in conjunction with the drafting of trade legislation speaks to the importance and complexity of those links.

The trade policy problems facing the United States are due in significant degree to the unusually wide swings in exchange rates during the last few years and to the difficult debt problems confronting a large number of less-developed countries that normally provide large markets for capital goods and other exports from the United States.

By joining with other industrial countries and the less developed countries in seeking to improve exchange rate behavior and reduce debt burdens, we can expect to solve our trade problems constructively without erecting new trade barriers or trying to extract unilateral trade policy concessions from other governments, concessions that can and should be negotiated multilaterally during the Uruguay round of trade negotiations.

I am particularly pleased that the Chairman of the subcommittee has tried to broaden the debate about the debt problem by making new proposals of his own. I tried to do this 4 years ago, soon after the problem became acute, and was told that my proposals were both unrealistic and unhelpful. Unrealistic because the U.S. Congress would not touch them, and unhelpful, because they might impair confidence in the conventional debt strategy and damage the creditworthiness of the debtor governments.

There is a close resemblance between the Senator's suggestions and those I made 4 years ago, which makes me even happier.

Mr. Chairman, my invitation to testify arrived just a few days ago, and I was forced to make a difficult choice, whether to put aside the preparation of my classes in order to draft a statement for these hearings or to prepare my lecture notes and come before you without the usual written statement. As your daughter is one of our undergraduates, I trust you will endorse my decision to spend my time on my lectures [laughter] and speak to you today informally.

Senator SARBANES. You put me in a very difficult position.

Mr. KENEN. No more difficult than mine, sir.

I have prepared some background materials, including an updated outline of my 1983 proposals and tables that summarize the present situation. I will ask that you have them inserted in the record after these opening remarks.

I will concentrate on the debt problem, but I promise—or threaten—to chime in when the discussion turns to exchange rate policy.

Let me pose and try to answer 4 questions about the debt problem.

First, why should we be looking at new ways to deal with it?

Second, what objectives and desiderata should we apply when looking at new solutions?

Third, how well do the Senator's own proposals and those I made some years ago meet those objectives and desiderata?

Finally, what pitfalls and problems should we bear in mind?

THE INTERNATIONAL RECESSION OF 1982

At the end of 1986, the debts of developing countries were 25 percent larger in dollar terms than they were in 1982, when the debt crisis broke out. They total more than \$1 trillion. Most of this additional lending was not voluntary. It reflected attempts by banks and other lenders to help debtor countries meet their interest payments. Banks usually object quite strongly to the capitalization of interest payments, but that is what they have been doing in this particular instance. Putting the point less generously, banks have propped up their earnings by weighing down their balance sheets with additional claims on the heavily-indebted countries.

When a debtor runs into temporary trouble, it makes good sense for him to borrow more to keep up his debt payments and thus preserve his creditworthiness. From the start of the debt crisis, however, it was clear that many debtors had deep-seated problems that would not be solved quickly. There were, of course, a number of special conditions that were likely to prove temporary: the deep international recession of 1982 and the sharp increase in interest rates before that recession. But longer-lasting changes were at work and would force the debtor countries to make painful adjustments.

In the 1970s, many debtors were able to borrow at negative real interest rates. Real rates are positive today and likely to stay that way.

The decline in oil prices has helped oil-importing countries but harmed oil-exporting countries much more sharply.

More generally, commodity prices have stayed at very low levels, although they were expected to rise when the dollar began to depreciate in 1985.

Governments, international organizations and individual experts have repeatedly predicted improvements in the ratios that are usually used to measure progress in dealing with debt problems. Yet the ratio of debt to GNP has risen for all debtors taken together and for the Baker countries, as well, and the ratio of debt to exports has risen more sharply. The debtors' interest payments have not fallen much, relative to exports, despite the recent fall in interest rates.

Only one set of numbers has moved in the right direction. The ratios of U.S. bank exposure to bank capital have fallen steadily, because of small reductions in the banks' exposure and large increases in their capital.

Some countries have made progress in dealing with their problems, but at high economic and social cost. Growth rates of real GDP have been quite low in most debtor countries, especially in the heavily indebted countries. GDP per capita actually fell in 1982-84 and was lower in 1986 than in 1982.

INVESTMENTS DROP SHARPLY

Levels of investment have dropped sharply, which foretells slow growth in the future. There have been deep cuts in social services, resulting, among other things, in higher infant mortality rates. Furthermore, progress on the external side in making debt service payments has had retrogressive domestic effects in some developing countries. Countries that devalued their currencies and raised domestic interest rates to discourage capital flight found it harder to bring down their budget deficits. The higher cost of foreign currency and higher interest rates combined to raise the cost of servicing both foreign and domestic debt. I need not remind Members of the U.S. Senate that budget deficits are hard to cut. They are exceedingly hard to cut in countries where debt service payments account for more than 50 percent of total spending.

In 1985, at Seoul, Secretary Baker proposed a new approach to the debt problem. The slogan was "Adjustment with Growth." The method was an increase of lending by banks and official institu-

tions to foster structural reforms that could raise productivity in the debtor countries. The results have been rather disappointing. The banks have not lent as much as Secretary Baker expected, and we do not really know how to combine adjustment with growth, when the requisite adjustment calls for fiscal austerity, as it does in most of the debtor countries.

As for the principles and desiderata that should guide any new approach to the debt problem, it seems to me that no such approach can be expected to relieve debtor governments of the need to marshal domestic political support for painful policies. That is not the aim of debt relief. Yet debt relief can disarm the critics of those policies who claim that foreign banks would be the main beneficiaries. More importantly, debt relief can lighten the burdens of debt service.

Many banks have come to realize that their claims on developing countries are worth much less than the face value of those claims. Some have sold them at a discount in the newly emerging secondary markets or built up larger loan loss reserves against them. But these steps have not helped the debtor countries, who must still struggle to pay interest on the face amounts and to amortize their debts as they come due.

DEBT RELIEF

It is, therefore, time to contemplate debt relief, not as a substitute for other measures by debtors, creditors or creditor country governments, but rather as a way to make those other measures more palatable and more effective. Such relief should be based on three principles. (1) Banks should not be forced to grant debt relief but should be given the opportunity to do so, and they should be encouraged to do so by appropriate changes in regulatory arrangements. (2) Governments should not be forced to accept debt relief, if, in their judgment, they are close to restoring creditworthiness and would prefer to go that route by testing the market's willingness to lend to them voluntarily. (3) Some part of the cost of debt relief must be borne by the governments and citizens of the advanced industrial countries, including the United States, whose policies and policy failures were partly responsible for the sudden changes in the international economic environment that encouraged debtor governments to borrow too much then raised the costs of servicing their debts.

Let me add these three desiderata. First, I believe the debt relief should be available to all debtor countries, not just the poorest or those that have suffered most acutely in attempting to manage their problems. It may, nevertheless, be appropriate to grant additional relief to low income or very heavily burdened countries.

Second, debt relief should involve a permanent reduction in the amount of debt outstanding which would reduce immediately and permanently the level of interest payments and would reduce more gradually the level of amortization payments that will have to be made in the future.

Third, there should be a continuing dialogue between the international community, represented by the International Monetary

Fund and the World Bank, and the debtor governments concerning the policies that debtors should pursue.

As for specific proposals, Mr. Chairman, you will not be surprised to learn that your own plan and mine conform rather well to the criteria I have just enumerated. Both plans would establish a new international agency to buy debt from banks at a discount and pay for it by issuing new obligations. The discount rate should probably be in the neighborhood of 35 percent, though a case could be made for a schedule of discount rates ranging from 25 to 75 percent, if each debtor country was given the right to choose the discount rate that would be applied to its own debt and the amount of debt relief was tied to the size of that discount rate.

The obligations issued by the new agency would be guaranteed by the sponsoring governments, including the United States, which would put up the requisite capital. The new agency would then turn to the debtor countries and work out a new schedule of interest and amortization payments, based on the discounted value of the debt purchased from the banks.

The interest and amortization rates would have to be designed to permit the agency to meet its own obligations—the payments it would have to make to the commercial banks. The sponsoring governments should not have to subsidize the agency and may not even have to pay in cash. All the agency's capital could be callable.

I conclude by mentioning some pitfalls and problems. Three come to my mind. First, there is the difficult political problem of apportioning subscriptions among the sponsoring governments. You have suggested, Mr. Chairman, that Japan and Germany might make the largest contributions, because of their large trade surpluses. They would object, and for fairly good reasons. As they see it, the assets they have piled up in the last few years do not represent passive financing for their trade surpluses. On the contrary, they see their trade surpluses as the symptom of their citizens' desire to invest abroad. That is the same point, that Senator Gramm was making a few moments ago.

For that same reason, moreover, the German and Japanese Governments will not find it easy to mobilize the assets in question, which are held by private institutions and investors. Germany and Japan should be large subscribers to the capital of the agency, but not in a manner vastly disproportionate to the extent of their own banks' involvement in the debt problem.

REPLENISHMENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION

Second, careful consideration must be given to the competing needs of other international institutions. The International Development Association, IDA, needs to be replenished. The World Bank may soon seek a large increase in its capital. In 3 or 4 years, there may be need for another increase in the quotas of the International Monetary Fund.

In my view, Mr. Chairman, the replenishment of IDA is the most urgent item on the agenda, because it deals directly with the poorest countries, but it should be possible to create and finance a new debt-discounting agency before dealing with the medium-term needs of the World Bank and the IMF.

Finally, there is need for other measures to ameliorate the debt problem. I warmly endorse the suggestions by William Cline in recent testimony on the House side. He suggested, for example, that export credit agencies, such as the Export-Import Bank, should do more to meet the medium-term credit needs of many less-developed countries. He suggested that interest rates are not likely to fall much farther and may begin to rise. Therefore, this may be the time for debtors and creditors to review and revise the interest rate arrangements attaching to existing debt. It might be wise to substitute fixed rate debt for floating rate debt, even if this raises the interest rates that debtors have to pay right now.

Finally, members of the Paris Club should review the principles and practices that govern their relations with the less developed countries. If banks are to give debt relief, governments should do so too, in their capacity as major creditors.

Thank you, Mr. Chairman.

[The complete prepared statement of Peter B. Kenen follows:]

OUTLINE OF A PROPOSAL FOR AN INTERNATIONAL DEBT DISCOUNT CORPORATION

Peter E. Kenen
Princeton University

March 1987

This note outlines more completely the proposal for an International Debt Discount Corporation (IDDC) that I made in *The New York Times* in March 1983. [A first version of this outline was circulated in May 1983. The current version differs mainly in the sizes of key numbers: the discount rate at which the IDDC would purchase debt from banks, the maturities of the obligations issued by and to the IDDC, and the interest rates on those obligations. It also makes reference to new options and arrangements, such as Enhanced Surveillance, that have come into use since 1983.]

I. Creation of the Corporation

The International Debt Discount Corporation (IDDC) would be created by the governments of the United States and other developed countries, described hereafter as the sponsors. (Saudi Arabia, Kuwait, and other countries whose banks have participated regularly in syndicated lending to the developing countries should also be encouraged to act as sponsors.) The IDDC could be established as an independent entity, as an affiliate of the World Bank, or as a facility to be managed by the International Monetary Fund, under Article V, Section 2(b) of the Fund's Articles of Agreement.

The capital of the Corporation would be subscribed by the sponsors. As the capital would be used exclusively to guarantee the obligations issued by the IDDC and for no other purpose, the whole capital could be callable; sponsors would not need to pay in cash. Although the capital of the IDDC should be fairly large in relation to its obligations--the bonds it would issue to pay for debt purchased from commercial banks--it would not have to match those obligations fully.

Subscriptions to the capital of the IDDC might be made in proportion to the sponsors' subscriptions to the capital of the World Bank, their quotas in the International Monetary Fund, their obligations under the General Arrangements to Borrow, or some other formula. [The most obvious formula under the circumstances, one based on the external claims of the sponsoring countries' banks, runs into the usual problem--assigning "responsibility" for the claims of off-shore branches and jointly owned subsidiaries--and has other defects too.]

As most of the debts of developing countries are denominated in U.S. dollars, the assets, liabilities, and capital of the IDDC should probably be denominated in dollars. [Sponsors other than the United States and many debtor governments should perhaps prefer to denominate the assets, liabilities, and capital in Special Drawing Rights (SDR) and likewise to use the SDR interest rate as the basis for the interest rates earned and charged by the IDDC, but that might make the arrangement less attractive to

commercial banks, whose willingness to accept the IDDC's obligations would be crucial to the success of the whole plan.]

II. The Business of the Corporation

The Corporation would issue its own long-term obligations to commercial banks in exchange for their claims on developing countries. The claims in question would be those issued or guaranteed by the governments of the developing countries, not private entities, would be limited to claims having an original maturity longer than one year, and should probably exclude claims issued after a cut-off date prior to the creation of the IDDC. The IDDC should not deal in claims guaranteed by the governments of developed countries (e.g., export credits).

The Corporation should discount those claims by 30-40 per cent, to allow it to grant significant debt relief to the debtor countries and build up a modest reserve for itself. [It has been suggested that the IDDC should post a schedule of discount rates resembling, if not based upon, the range of discount rates that are quoted in the secondary market for similar debt instruments. There are practical objections to the use of market discount rates for this purpose, but there should be no objection in principle to the posting of several discount rates ranging from 25 to 75 per cent, if each debtor government is allowed to choose or agree to the discount rate which will be applied to its own obligations and if the amount of debt relief received by each government is keyed to its choice of discount rate.]

Before doing any business with the commercial banks, the Corporation would enter into a standard agreement with each debtor government. Each government must agree to recognize the IDDC as successor to the commercial banks holding that government's obligations and must also agree to the IDDC's repayment terms. [With multiple discount rates, moreover, it would have to agree to the rate that the IDDC would apply to its debt.] The repayment terms are described below.

The Corporation should deal only with developing countries that are members of the International Monetary Fund and have entered into a stand-by arrangement with the Fund or agreed to some form of Enhanced Surveillance. [In some cases, it may be appropriate for the requisite review of the government's policies to be conducted by the World Bank rather than the Fund.]

Commercial banks should not be required to do business with the IDDC, but those that choose to do so should meet these terms and conditions:

- (1) Banks should not be allowed to discount their claims on some developing countries and keep their claims on others. A bank wanting to discount any of its claims on any of the debtor countries doing business with the IDDC should be required to discount a uniform fraction of all its claims on all such countries.

(2) Banks should not be allowed to decide for themselves when they will turn to the IDDC. The Corporation should open its "discount window" for a limited period, no longer than 6 to 12 months, and then close it permanently. [By the same token, the governments of debtor countries should have a limited period in which to decide whether they will do business with the IDDC; the "discount window" would be opened at the end of that period.]

Sponsoring governments would agree to make such changes in their banking laws and regulations as might be required to permit their own banks to deal with the Corporation. In particular, banks should not be required to "mark to market" claims on debtor countries that remain in their portfolios when those banks or others have discounted comparable claims with the IDDC. Furthermore, banks should be permitted to amortize gradually the losses they incur when they discount debt with the IDDC; losses larger than, say, 10 per cent of capital (including general loan-loss reserves) might be amortized over a 5-year period.

III. Terms and Conditions

The bonds issued by the Corporation should be amortized over a 30-year period, beginning 5 years after issue. They should be issued at an interest rate no higher than 1 percentage point above the then-current interest rate on long-term U.S. Government securities. The interest rate might float partially thereafter, rising by half of any increase in LIBOR (or some other short-term rate) and falling by half of any decrease.

The bonds should be marketable, and the Corporation should encourage the development of a secondary market for its issues. Furthermore, the Corporation should be empowered to redeem its bonds by issuing new ones, either directly to the holders of the maturing bonds or in the open market.

Claims discounted by the Corporation should be converted into long-term debt at or modestly above the discounted value of those claims. [The difference between the face value of the new claims and the discounted value of the old ones would yield a "profit" to the Corporation that would be used to build up a reserve and might also be used for selective interest-rate relief, along lines described in the final paragraph of this outline.]

Debt to the Corporation should be amortized over a 25-year period, after a 3-year grace period. It should bear an interest rate no more than 50 basis points above the average rate on the bonds issued by the Corporation. If interest rates paid by the Corporation floated partially, those charged by the Corporation would have float in the same manner.

There may be room for some further differentiation. The International Monetary Fund might be asked to identify countries having "exceptional" debt-service burdens. Such countries could be given a 5-year or 10-year grace period and charged an interest rate no higher than the rate on the IDDC's own bonds. [They could be subsidized more generously with some of

the "profits" of the Corporation--with part of the difference between the value of the IDOC's claims on debtor countries and the discounted value of the claims acquired from commercial banks. If this were done, however, the sponsors would have to pay in some capital; cash would have to be "advanced" until the IDOC was able to realize the "profits" represented by the difference between the amortization payments made by its debtors and the amortization payments made to its creditors.]

Table 1 Total External Debt of Developing Countries (billions of dollars)

Category	1982	1983	1984	1985	1986 ^e	1987 ^p
All debt and all countries	825	890	929	992	1,035	1,080
Countries in WB DRS ¹	739	797	833	892	932	972
Long-term debt ²	551	630	673	731	775	812
Short-term debt ²	187	167	159	161	157	160
Other countries	86	93	96	100	103	108
Long-term debt ²	60	67	68	74	77	83
Short-term debt ²	26	26	28	26	26	25

Source: World Bank, World Debt Tables, 1986-87 Edition.

¹The 109 countries covered by the World Bank's Debt Reporting System.

²Includes debt to the International Monetary Fund.

^eEstimated.

^pProjected.

Table 2 Total External Debt of Countries in WB DRS (billions of dollars)

Category	1982	1985
Total External Debt		
All countries	738.7	892.4
Baker fifteen ¹	382.2	436.4
Baker countries as percent of total	51.7	48.9
Long-Term Debt		
All countries	551.2	730.9
Baker Fifteen ¹	271.5	360.7
Baker countries as percent of total	49.2	49.4
Government and Guaranteed Long-Term Debt		
All countries	448.2	631.9
Baker fifteen ¹	193.9	297.8
Baker countries as percent of total	43.3	47.1
Government and Guaranteed Long-Term Debt Owed to Financial Markets		
All countries	227.8	336.6
Baker fifteen ¹	142.2	221.2
Baker countries as percent of total	62.4	65.7
Private Nonguaranteed Long-Term Debt		
All countries	103.0	99.0
Baker fifteen ¹	77.6	62.9
Baker countries as percent of total	75.3	63.5
Short-Term Debt (including debt to IMF)		
All countries	187.5	161.5
Baker fifteen ¹	110.8	75.7
Baker countries as percent of total	59.1	46.9

Source: World Bank, World Debt Tables, 1986-87 Edition.

¹ Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Table 3 Interest Payments on Long-Term Debts of Countries in WB DRS (billions of dollars)

Category	1982	1986	1987 ^P
On All Long-Term Debt			
All countries ¹	48.6	54.5	na
Baker fifteen ¹	30.7	32.6	na
On Government and Guaranteed Long-Term Debt			
All countries ¹	35.7	44.1	48.5
Baker fifteen ¹	20.5	25.3	27.1
Of which payments to private creditors ²			
All countries	27.7	32.7	33.1
Baker fifteen ¹	17.9	21.5	21.8
Interest Payments on Government and Guaranteed Long-Term Debt as Percentage of Exports of Goods and Services	8.3	9.6	na
All countries	8.3	9.6	na
Baker fifteen ¹	14.4	17.5	na

Source: World Bank, World Debt Tables, 1986-87 Edition.

¹See note 1 to Table 2.

²In 1985, interest payments to financial markets accounted for 94.5 per cent of interest payments to all private creditors; the corresponding figure for the Baker fifteen was 98.6 per cent.

^PProjected.

Table 5 Exposure and Capital for Groups of U.S. Banks (billions of dollars)

Category	June 1982	June 1986	September 1986
All Banks Filing Country Exposure Reports			
Exposure to All Developing Countries	125.0	113.1	110.4
Exposure to Baker Fifteen ¹	90.3	87.0	85.8
-Capital	66.2	110.7	113.0
Exposure as Percentage of Capital			
To All Developing Countries	189	102	98
To Baker Fifteen ¹	136	79	76
Argentina	13	8	8
Brazil	31	21	21
Mexico	38	22	21
Venezuela	16	9	8
Nine Money Center Banks			
Exposure to All Developing Countries	77.7	73.8	72.3
Exposure to Baker Fifteen ¹	54.5	57.0	56.4
Capital	27.1	44.2	45.2
Exposure as Percentage of Capital			
To All Developing Countries	287	167	160
To Baker Fifteen ¹	201	129	125
Argentina	21	14	14
Brazil	46	36	35
Mexico	50	31	30
Venezuela	26	15	15
Fourteen Other Large Banks ²			
Exposure to All Developing Countries	24.3	20.3	19.7
Exposure to Baker Fifteen ¹	17.8	15.6	15.2
Capital	12.7	21.5	21.7
Exposure as Percentage of Capital			
To All Developing Countries	192	94	91
To Baker Fifteen ¹	140	72	70
Argentina	14	8	8
Brazil	33	19	19
Mexico	41	22	21
Venezuela	15	7	7

Source: Federal Financial Institutions Examination Council, Quarterly Country Exposure Reports.

¹See note 1 to Table 2.

²Fifteen banks in 1982 (reduced to fourteen by merger).

Senator SARBANES. Thank you, Mr. Kenen. Mr. Bergsten.

**STATEMENT OF C. FRED BERGSTEN, INSTITUTE FOR
INTERNATIONAL ECONOMICS**

Mr. BERGSTEN. Mr. Chairman, Professor Kenen has focused on Third World debt. I would like to focus on First World debt—our own—and particularly the trade deficit, the exchange rate problem and the international monetary system.

I want to put it very pragmatically in the context of the trade legislation that the Congress is now focusing on, because I think here you have an enormous opportunity. I know the committee is considering what it will contribute to the Omnibus Trade legislation, which is now wending its way through the House. The Senate, I gather, will be taking it up in spring or early summer.

I focus on that because, Mr. Chairman, I believe that this committee's component of the Omnibus Trade legislation could, in fact, be the most important part of the whole trade bill that Congress looks at this year. The reason I say that is because all the focus on competitiveness and our trade deficit sometimes forgets the point that the key cause of our competitive problem these last 5 years, and our trade deficit, has been the enormously overvalued exchange rate for the dollar, and behind that macroeconomic policy changes in this country and abroad.

So if the Congress wants to seriously address the trade deficit in the trade legislation, it has to work seriously on the exchange rate and the other macroeconomic issues. That is what I would recommend that this country do.

COMPETITIVE EXCHANGE RATE ACT

As you know, the House Banking Committee has made a start. They have a component of the Omnibus legislation called the Competitive Exchange Rate Act, which attempts to change the procedures under which U.S. international monetary policy is created and pursued. I would like to recommend that this committee do something along the same lines. The objective of that legislation is very simple. It is basically to bring the exchange rate and international monetary issues out of the closet where, in my view, they have lain too long. It sounds surprising, in a sense, that the country has never had any target for our external balances. We have never really had any targets for the exchange rate of our currency. The Congress has never gotten engaged in that process in an ongoing way, yet I think most of us would take the view that those issues are critical to the health of the entire economy, and certainly to our trade balance and competitive position.

It is obviously impossible to legislate a correct exchange rate for the dollar, and I am not recommending it. The Congress, however, can legislate a process that I think would enhance the prospects for maintaining the exchange rate at a competitive level, just as it has legislated a process that helps determine monetary policy. The central problem is that American Administrations and the Congress, as well, have tended to ignore the exchange rate or view it as simply a residual component of "purely domestic policy areas," such as the budget and monetary policy.

I would argue that the Congress needs to take action to assure that American trade competitiveness is taken fully into account in policy toward the dollar and the international monetary system. As I say, it is vital to bring exchange rate policy out of the closet, and therefore, I applaud what the House has done and recommend that the Senate, through this Banking Committee, also move in a similar direction.

Now what the House has done, as I read it, is basically four things. They would require the Secretary of the Treasury, after consultation with the Chairman of the Federal Reserve Board, to set targets for the U.S. trade balance and current account position. He would have to set targets for the exchange rate of the dollar which would achieve those desired levels. He would have to indicate how he intends to achieve those targets, including, critically, through domestic economic policies which will be consistent with them, and he would have to report frequently to the Congress on his progress in achieving the agreed goals and what policy changes might be needed to do so.

In essence, the Congress would be asking the administration to become accountable on these critical international economic and financial issues.

With a process of this type, as is proper, the Secretary of the Treasury would retain full flexibility in managing our international monetary policy, and could assure that these targets that I'm talking about come about as ranges rather than precise points.

The process would have to engage the Congress and, therefore, the public in setting the goals of international monetary policy and the broad strategies for pursuing them.

I think that such a system could sharply reduce the risks of a future period of benign neglect of the exchange rate and, thus, of our competitive position in the world economy.

In a nutshell, Mr. Chairman, I'd like to make the world safe against any future Beryl Sprinkels, who ignored the issue for 5 years, thereby creating a trade deficit of \$170 billion and decimated much of American industry and agriculture.

Now, of course the exchange rate of the dollar cannot be determined solely by the United States. It's an international issue. And, therefore, part of this approach would also be to pursue reform of the international monetary system, in my view, in the direction of target zones or the reference ranges which the administration itself is now pursuing.

That, too, would be part of the approach and I think should be part of the proposal that this committee might put into the overall trade bill.

THE GEPHARDT AMENDMENT

Finally, Mr. Chairman, one last practical—I hope—proposal. The most disturbing part of the trade legislation that is emerging from the House is the Gephardt Amendment, which has been characterized widely and I think, to a large extent correctly, as running a very big risk of the United States going protectionist and unilateralist in its trade policy.

Having said that, it's got to be acknowledged that the Gephardt Amendment addresses a very serious and very real problem; namely, excess surpluses, as the amendment calls them, on the part of other countries—whether it's Japan or Taiwan, these are excessive surpluses that mirror our excessive deficits.

It's, therefore, proper policy to go after those. And as Secretary Mulford indicated, the Administration is doing so. The problem with the Gephardt Amendment is it goes after them in a totally ineffectual way. It identifies the problem but then says: Go after their unfair trade practices.

We know that, whereas it's very important to get rid of their unfair trade practices, even doing so with total success would have a modest impact in reducing their excessive surpluses.

What you need to do, as Secretary Mulford said, is get changes in their macroeconomic policy and their exchange rates.

And so what I would suggest is to take the kind of approach I'm proposing here, and which the House Banking Committee has already addressed, to go after those exchange rate and macroeconomic policies.

Blend those responses with the problem correctly identified by the Gephardt Amendment and, in the Senate, come up with a reasonable, responsible and potentially effective remedy to what is one of the serious international financial problems that the country faces today.

Thank you very much.

[The complete statement of C. Fred Bergsten follows:]

Table 4 Debt Ratios and Other Economic Indicators for Capital-Importing Developing Countries

Category	1982	1983	1984	1985	1986 ^e	1987 ^P
Ratio of external debt to gross domestic product (%)						
All countries	33.8	36.3	36.9	40.1	40.4	38.9
Baker fifteen ¹	42.2	48.0	46.3	45.7	46.6	45.4
Ratio of external debt to exports of goods and services (%)						
All countries	151.3	160.7	154.0	168.8	179.5	173.0
Baker fifteen ¹	269.2	289.5	270.3	285.1	324.8	311.0
Ratio of interest payments to exports of goods and services (%)						
All countries	14.2	13.5	13.6	13.6	13.0	11.7
Baker fifteen ¹	30.7	29.9	29.0	28.1	28.1	24.0
Trade balances (billions of dollars)						
All countries	-50.0	-16.4	16.7	9.9	-6.6	-6.9
Baker fifteen ¹	3.7	29.1	44.1	40.7	24.5	22.3
Change in terms of trade (%)						
All countries	-2.1	-1.5	1.9	-1.7	-8.3	-2.9
Baker fifteen ¹	-4.2	-3.7	2.4	-2.7	-15.9	-2.8
Growth rates of real gross domestic product (%) ²						
All countries	2.0	1.7	4.8	4.1	3.2	3.4
Baker fifteen ¹	-0.5	-3.5	2.1	3.3	2.5	3.5
Growth rates of real gross domestic product per capita (%) ³						
All countries ¹	-0.3	-0.5	2.6	2.0	0.9	1.2
Baker fifteen ¹	-2.8	-5.6	-0.2	1.1	0.3	1.2
Ratio of investment to gross domestic product (%) ⁴						
All countries	24.9	22.8	22.5	22.1	22.0	na
Baker fifteen ¹	22.3	18.1	17.4	16.9	17.4	na

Table 4 (continued)

Category	1982	1983	1984	1985	1986 ^e	1987 ^f
Ratio of central government fiscal deficit to gross domestic product (%)						
All countries	4.8	4.6	3.6	3.6	4.3	na
Baker fifteen ¹	4.3	4.4	2.2	1.9	3.2	na

Source: International Monetary Fund, World Economic Outlook, October 1968; country coverage and definitions of debt differ from those in World Debt Tables.

¹See note 1 to Table 2.

²The growth rate of real gross domestic product averaged 4.5 per cent in 1978-81; the corresponding figure for the Baker fifteen was 4.7 per cent.

³The growth rate of real gross domestic product per capita averaged 2.3 per cent in 1978-81; the corresponding figure for the Baker fifteen was 1.3 per cent.

Table 6 Effects of Partial Debt Rediscounting (billions of dollars)

Category	Applied to Baker Fifteen	Applied to All Debtors
Calculations assume that banks would turn in half of their long-term claims on the eligible countries and that the IDDC would take them at 35 percent discount:		
Debt to be issued by the IDDC in exchange for banks' claims on eligible countries [half of long-term government and guaranteed debt outstanding at the end of 1985 <u>less</u> 35 percent discount]	71.9	109.4
Reduction in indebtedness of debtor countries [half of long-term government and guaranteed debt outstanding at the end of 1985 discounted by 35 percent]	38.7	58.9
Reduction in annual interest payments by debtor countries, assuming no substantial change in interest rate resulting from transfer to IDDC [based on interest payments on long-term government and guaranteed debt in 1986]	3.8	5.7
Reduction in interest payments as percentage of exports of goods and services ¹	2.9	1.0
Loss to U.S. banks [based on exposure in September 1986] ²		
Nine large money center banks	9.9	12.6
Fourteen other large banks	2.7	3.4
All banks	15.0	19.3
Loss to U.S. banks as percentage of capital		
Nine large money center banks	21.9	29.9
Fourteen other large banks	12.4	15.7
All banks	13.3	17.1

Source: Basic data from Tables 2, 3, and 5.

¹Exports of goods and services from International Monetary Fund, World Economic Outlook.

²May overstate or understate actual loss, because exposure data include all of banks' claims on debtor countries, not just long-term claims eligible for sale to the IDDC, but they are net of deposit and other liabilities to the debtor countries.

Senator SARBANES. Thank you.
Professor Cooper.

STATEMENT OF PROF. RICHARD COOPER, HARVARD UNIVERSITY

Mr. COOPER. Thank you, Mr. Chairman. I propose to make some observations in response to the questions that were put to me, on existing exchange rates, on the exchange rate system, and on the external debt crisis. Finally, I will address the question of legislation.

On the first point, I would not push exchange rates further as a policy objective, by which I mean the exchange rates of the dollar against the yen and against the leading Continental European currencies. Japan and Germany, have not yet absorbed the changes that have taken place already, and a further sharp rise in their currencies risks economic recession in Japan and Germany, which would not be in anyone's interest, including the interests of the United States. It could even precipitate a full-pledged international financial crisis out of the current debt problems, which I'll take up below.

The dollar will probably have to drop against those currencies during the next 5 years, although it's too early to tell even that for sure. It is worth noting that the dollar is not yet back to its 1980 level with respect to the leading industrial currencies, on the Morgan Guaranty U.S. trade-weighted index of effective exchange rates.

And our trade balance is not likely to show a marked improvement until the second half of this year, provided that world investment does not slump. I emphasize investment rather than foreign growth because U.S. exports are especially sensitive to the rate of investment in the rest of the world. It is mainly insofar as investment is related to the rate of growth that our exports are sensitive to growth rates.

To move on from the existing exchange rates to the exchange rate system, I believe that, in the long run, we will want to move to a single currency among industrial democracies because the productive sectors of our economies will find intolerable the erratic movements in real exchange rates that are driven by financial flows rather than by economic developments in the non-financial parts of the economy. But the political and economic conditions are not yet suitable for such a radical move. In the meantime, we will have to manage exchange rates as best we can.

Whether to manage them via a commitment to exchange rate targets or via coordination of macroeconomic policies among major countries is, in part, merely a semantic issue, as whether the chicken or the egg must come first.

What we have to be clear about is that a serious commitment to influence exchange rates in one of their various forms itself requires coordination of policies, so these are not alternatives; they are complements to one another.

TARGET ZONES

The proper question is how one best brings about the coordination of policies and, in particular, whether one does it by agree-

THE DOLLAR, THE INTERNATIONAL MONETARY SYSTEM
AND THE TRADE LEGISLATION

Statement

by

C. Fred Bergsten

Director

Institute for International Economics

Before the

Subcommittee on International Finance
and Monetary Policy

Senate Committee on Banking, Housing and Urban Affairs

March 26, 1987

The Dollar and American Competitiveness

In my view, the Competitive Exchange Rate Act (Title IV, Subtitle A) is the most important component of the entire trade legislation (H.R. 3) now being considered by the House of Representatives. Some of the objectives of that title are also included in a bill proposed last fall by Senator Heinz (S. 2815). I strongly urge this Committee to seek the inclusion of such provisions in any trade legislation considered in the Senate this year. Indeed, I believe that these provisions offer a constructive alternative to the Gephardt Amendment--the most objectionable part of the trade legislation now being debated in the House.

I stress these issues because the value of our currency, during most periods, is by far the most important element in determining the international competitiveness of the American economy. The overvaluation of the dollar, which began by mid-1981 and peaked at more than 40 percent in early 1985, was

responsible for three quarters of the enormous trade deficit with which the Congress is now grappling. Every percentage point of dollar overvaluation costs our trade balance about \$3 billion and 75,000 jobs.

The substantial correction of the exchange rate that has occurred since early 1985 is enormously welcome, and should produce a reduction of \$30-40 billion in the trade deficit this year and again in 1988. However, the imbalance will not fall much below \$100 billion on present policies so considerably more adjustment--probably including further exchange rate changes--is needed.¹

This is not the first time that dollar overvaluation and its underlying economic causes, in this recent case primarily our huge budget deficits, have plunged American trade into deficit and led to a substantial export of jobs and profits (and unleashed understandable if misguided pressures for protectionist trade policies, as reflected in some other components of the legislative proposals now before the Congress). The dollar became overpriced by about 20 percent in the late 1960s and early 1970s, producing the prolonged international monetary crisis of 1971-73 which required two devaluations to resolve. It became overvalued again in 1976-77, leading to record trade deficits at that time and to the "dollar crisis" of 1978.

1. For details see C. Fred Bergsten, "Economic Imbalances and World Politics," Foreign Affairs, Spring 1987 (to appear on April 3).

In each of these cases, neglect by the current Administration of the centrality of the exchange rate for American competitiveness was an important element in the trade deterioration which resulted. The term, "benign neglect" was in fact first applied in an international context to describe the failure of the Nixon Administration to halt the growing overvaluation of the dollar in 1969-71. The Ford Administration did nothing to stop the dollar's rise in 1976. Most egregiously, the Reagan Administration cheered the rise of the dollar until September 1985 as an indication that the country's economy was strong and healthy, ignoring (1) the resulting decimation of American manufacturing and agricultural exports and (2) our shifting from world's largest creditor country in 1982 to world's largest debtor now, with net external liabilities greater than those of Brazil and Mexico combined.

American policy toward the dollar, however, has been flawed under Democratic as well as Republican regimes. The Johnson Administration triggered the first major overvaluation by its failure to responsibly finance the growth of government spending on the Vietnam War and Great Society. The Carter Administration corrected the modest overvaluation which it inherited, and in fact spurred an export boom in 1978-80, but had to mount a major rescue program in late 1978 and endorse the Fed's sharp tightening of monetary policy in late 1979 to halt an excessive dollar decline (which had an important impact on inflation and on global confidence in American economic policy).

It is thus clear that US international monetary policy has been erratic and ineffectual in maintaining an equilibrium exchange rate for the dollar.² Such a rate is essential to protect both our international competitiveness (against dollar overvaluation) and internal price stability (against dollar undervaluation). I believe that legislation along the lines of the Competitive Exchange Rate Act, included in H.R. 4800 last year and voted again by the House Banking Committee last week, would help deal with both problems.

Promoting a Competitive Exchange Rate for the Dollar

It is impossible to legislate a "correct" exchange rate for the dollar, just as it is impossible to legislate "correct" interest rates or other policy instruments which must respond to rapidly changing market forces in a global economic setting. The Congress can, however, legislate a process that will enhance the prospects for maintaining the exchange rate at a competitive level--just as it has legislated a process that helps determine an appropriate monetary policy. The Congress has in fact been derelict in exercising its responsibilities in the exchange rate area, and a correction of that situation could represent the single most important contribution of the pending trade legislation.

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2. For details see C. Fred Bergsten, "America's Unilateralism" in Conditions for Partnership in International Economic Management, New York: The Trilateral Commission, 1986.

The central problem is that our Administrations, and the Congress as well, tend all too often to regard the exchange rate and the trade balance as residual components of the economy which simply derive from the interplay of "purely domestic" elements such as the budget and monetary policy. In fact, changes in the trade balance have become a driving force for our overall economy--accounting for its total growth in 1979-80, cutting growth in half in 1985-86, and being pivotal to whether we can avoid recession over the next two years.³ Moreover, the United States will have to move over the next few years into merchandise trade surplus--a swing of \$150-200 billion from where we would otherwise be--to enable us to service our growing foreign debt without building that debt even further in the future.

The Congress needs to take action to assure that American trade competitiveness is taken fully into account in US policy toward the dollar. To be sure, other factors are crucial as well: an excessively declining dollar would generate undesirable inflationary pressures, as in 1978, and should also be avoided. At the moment, any effort to push the dollar down too rapidly would run the risk of losing control and precipitating a "free fall" which could force up interest rates and trigger a recession.

3. Virtually all forecasts for economic growth in 1987 and 1988 depend on a substantial improvement in the real trade balance (of at least 1 percent per year) to avoid a growth recession (growth of less than 2 percent, with unemployment rising as a result). Further deterioration of the trade balance could create a full-blown recession.

As an ongoing systemic matter, however, it is vital to bring exchange rate policy out of the closet--where it has lain too long in this country, protected by the mystiques of international finance without adequate attention to its impact on the "real" economy of trade and jobs. Hence I applaud and strongly support the procedures required in the Competitive Exchange Rate Act under which the Secretary of the Treasury, after consultation with the Chairman of the Federal Reserve, would be required to:

- set targets for the US trade balance and current account position;
- set a target for the exchange rate of the dollar which would achieve these desired levels;
- indicate how he intends to achieve these targets, including through domestic economic policies which would be consistent with them;
- report frequently to the Congress on his progress in achieving the agreed goals, and what policy changes might be needed to do so.

Such a system would, as is proper, leave full flexibility to the Secretary in managing the international monetary policy of the United States. The targets for our external position and exchange rate would have to encompass ranges rather than single

points, and would have to envisage different combinations of economic growth and other key variables in the United States and abroad. But the process would actively engage the Congress, as is also proper, in setting the goals of international monetary policy and the broad strategies for pursuing it. Such an improved system should sharply reduce the risks of future periods of "benign neglect" of the exchange rate, and thus of America's competitive position in the world economy.

International Monetary Reform

By definition, however, the exchange rate of the dollar cannot be determined solely by the United States. Currency values, and thus competitiveness and trade balances, derive from the interplay between national economies. As noted above, the international monetary system has failed to prevent huge currency and trade imbalances on numerous occasions over the past two decades. A second imperative of policy reform in this area is thus to seek reform of the international monetary system.

Fixed exchange rates collapsed in the early 1970s because they proved to be too rigid, failing to produce needed currency changes without huge crises and becoming increasingly vulnerable to the growing level of international capital movements. Flexible exchange rates are now demonstrably inadequate, permitting massive misalignments to occur and failing to exert any effective pressure on countries to adopt internationally compatible--and thus sustainable--national economic policies. We

need a synthesis between these two extremes, in which rates can move freely in response to short-term disturbances but are kept from diverging too far from underlying equilibrium--and thus creating huge trade imbalances and economic dislocations.⁴

I prefer a move to "target zones," in which the major countries would determine ranges of perhaps 15-20 percent within which they would pledge to maintain their exchange rates by direct intervention and, as necessary, by changes in monetary and other policies. Another variant is "reference ranges," which the Administration is reportedly pursuing, in which the aforementioned zones would trigger consultations but without any commitment to joint action. Another variant is "reference rates," where movement away from agreed equilibrium levels would also trigger consultations--but with no pre-agreement on how far such deviations had to go before talks would begin.

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Whatever the precise approach, it is essential to achieve reform of the international monetary system. I thus applaud and strongly support those provisions of the Competitive Exchange Rate Act and of S. 2815 which would direct the Secretary of the Treasury to move in that direction, consult with the Congress on his goals and plans, and report back on the results of these efforts.

4. For details see C. Fred Bergsten, "Stabilizing the International Monetary System: The Case for Target Zones," in John H. Makin, ed., Exchange Rate Targets: Desirable or Disastrous?, Washington: American Enterprise Institute, 1986, and John Williamson, The Exchange Rate System, Washington: Institute for International Economics, revised June 1985.

It is important for the Congress to recognize that its role in a reformed international monetary system will have to go far beyond consultation with the Secretary of the Treasury on the mechanics of exchange-rate policy. In a target zone system, for example, monetary policy would on occasion have to be altered to defend the agreed range for the dollar--with interest rates falling, for example, to keep the dollar from becoming too strong and thereby undermining our trade position. To avoid adverse inflationary effects on the economy, this might in turn require a rather prompt tightening of fiscal policy via some combination of expenditure cuts and tax increases.

The Congress, working of course with the Administration, will itself have to be increasingly attuned to the international dimensions of its actions (and nonactions) to make any new monetary regime work and to avoid adverse repercussions on our economy from changes in America's international position. Direct intervention in the currency markets, though frequently desirable and occasionally sufficient to avoid imbalances, will often be inadequate to achieve the purposes set out in the legislation before you. Meaningful changes in underlying policies, including fiscal policies, will be needed. I urge you to bear this imperative firmly in mind as you push for a more stable and effective US approach to international monetary problems.

In terms of specific provisions, there is no need to include a "Strategic Exchange Reserve" as in S. 2815 (and last year's version of the Competitive Exchange Rate Act in the House, which they dropped last week). That idea was understandable before

September 1985, when the Administration remained unwilling to use the resources of the Exchange Stabilization Fund (ESF) to intervene in the currency markets, but it has intervened substantially over the past eighteen months and there is no need to duplicate the ESF with a new fund.

Secondly, I would de-emphasize the holding of a new international conference to negotiate monetary reform. Section 403(b) of the House bill rightly calls for a conference or use of existing mechanisms, and I believe the latter is more pragmatic and likely to be more effective. Indeed, the topic has reportedly been under active discussion in the Group of Five and Group of Seven over the past months and any Congressional push should attempt to reinforce that process rather than create a new one.

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The Dollar and the Gephardt Amendment

Finally, I believe that the suggested provisions regarding the exchange rate and international monetary reform could be melded with the objectives of the Gephardt Amendment to substantially improve, in the Senate, the overall trade legislation now under consideration in the House.

The Gephardt Amendment correctly identifies the problem of "excess surplus countries"--the counterparts to our own excessive external deficits. However, it seeks to attack those excessive surpluses, where accompanied by "unjustifiable, unreasonable or discriminatory trade policies or practices," by negotiating a liberalization of such policies--or, failing a successful negotiation, by unilateral US retaliation against them.

The problem is that the other countries' surpluses, like the American deficits, result primarily from currency and underlying macroeconomic imbalances rather than from unfair trade practices.⁵ We should of course attack unfair trade practices wherever they are found, whether the perpetrators are running surpluses or deficits. But even the most effective attack on such barriers would have very modest impact on our trade deficit. Indeed, the original Gephardt Amendment sought a mere 10 percent annual reduction in the bilateral imbalances--essentially giving the surplus countries ten years to adjust! The Gephardt Amendment thus goes after an elephant with the proverbial popgun.

It would be far more effective to apply the remedies of the Competitive Exchange Rate Act to the problems identified at the outset of the Gephardt Amendment. The Act requires the Secretary of the Treasury to analyze the extent to which the currencies of each of our major trading partners diverge from the exchange rate at which the United States would be fully competitive with them (Section 405(c)). It then requires that he take steps to promote elimination of any such deviations, which would be by far the most decisive--and most rapid--way to reduce or eliminate our bilateral deficits (and, thus, our global deficit).

5. In the case of Japan, widely viewed as the most extreme surplus country addressed by the Gephardt Amendment, only \$5-10 billion of our bilateral imbalance of \$50-60 billion can be attributed to such practices. Moreover, US barriers to Japanese exports probably reduce their sales here by \$4-5 billion and our own export controls on Alaskan oil add \$2-5 billion to the bilateral deficit. See C. Fred Bergsten and William R. Cline, The United States-Japan Economic Problem, Washington: Institute for International Economics, revised January 1987.

The revised version of the Gephardt Amendment, developed and voted by the Trade Subcommittee of the Ways and Means Committee last week, acknowledges the importance of the currency issue by adding a provision which would require the Administration to negotiate with any "excessive surplus country" which "is maintaining its currency at an artificially low level." The key issue, however, is not whether such a country is manipulating its currency. It is whether that currency, for whatever reason, is out of line with underlying economic conditions. Whenever such a disequilibrium exists, adjustment is essential.

Hence a juxtaposition of the Gephardt Amendment and the Competitive Exchange Rate Act could significantly promote America's basic trade and competitiveness objectives. The Gephardt Amendment identifies a serious problem, the sizable surpluses of other countries. The Competitive Exchange Rate Act provides an appropriate and effective response, via changes in currency values and macroeconomic policies. I strongly recommend that the Committee meld these two, and thereby substantially improve the contribution of the pending trade legislation to remedying our massive trade deficit.

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ment with respect to exchange rates or by some alternative approach to policy coordination.

The policies that are especially need to be coordinated, in my view, are monetary policies. It should be perfectly clear that any serious commitment to an exchange rate target implies subordinating monetary policy to that commitment.

It does not in my view require formal coordination of fiscal policies. But market pressures—that is to say, the inability of governments to turn to their central banks for government deficit financing—will bring about some indirect coordination of fiscal policies. This latter is not an issue for the United States, since we typically do not rely on our central bank for financing of government deficits; but a number of other countries do.

I believe that it's premature to commit to target zones, or any other specific scheme with respect to exchange rate management, at the present time. But it is not premature to instruct the government of the United States, in collaboration with other countries, to undertake official international studies of the various schemes that have been suggested, with a view to assessing in a serious way both their workability and the collateral implications of adopting such schemes.

Some of that has been done of course by academic economists, but academic economists typically do not concern themselves with operational problems, which officials would have to think about if they were tasked to look at these schemes seriously, nor with the full range of collateral effects.

INTERNATIONAL DEBT

Let me turn now to the question of international debt. I divide the problem between the acute, very low income cases, largely in sub-Saharan Africa, and all others, mainly those in the Latin America. With respect to the latter countries, I see no feasible alternative to continuing the present policy of muddling through, although I would make some changes at the margin in the way that we're muddling through.

The basic problem is that too many economies have been squeezed for too long. That is not good economics. It is not good politics, especially in fledgling democracies.

In addressing the international debt issue, we need to shift the emphasis to economic growth. That requires more lending by the International Monetary Fund and by the World Bank than they've undertaken in recent years, and particularly last year.

And it requires more emphasis on sound economic recovery in the debtor countries rather than on maintaining the current low level of investment.

We are unlikely to get enough funds either through public or through private sources to accomplish this task, especially if the world economy continues to be as lackluster in its overall performance as it has been last year and as it looks as though it will be during 1987 and into 1988.

By a process of elimination, therefore, assuming that the growth-oriented strategy goes forward, we are going to see a greater build-up of arrearages by the debtor countries. If they cannot get new

funds through public or private sources, they have at their disposal a "line of credit" simply by not paying a portion of the interest on their outstanding indebtedness.

Most of these countries run trade surpluses, partly by having greatly squeezed domestic investment. Their problem is that the required interest payments exceed the trade surpluses. I would hope a buildup in arrearages would be intermittent and that it would be selective.

The question that the creditor community faces is how to deal with a situation in which arrearages are going up?

I would urge that the creditor community be tolerant of this development provided the economic policies in the debtor countries are on a basically sound path for economic recovery.

This has some particular implications. It means, for example, that the IMF should not wait, as it did in the case of the Mexican package, for the new private credits to be definitively put together before going ahead with its own lending. With Mexico we've seen the absurd situation in which a country badly needed funds, negotiated a satisfactory package last August and the IMF funds have still not been released seven months later.

They have been held up by the very difficult and practical problem of putting together the bank package. We should reverse the order on this. The IMF should make clear what amounts of money are needed. It should then leave it to the debtor country to work out with its creditors those amounts of money. Provided that the country's policy is appropriate it should release its own funds without waiting for all the details to have been worked out.

There are other implications. For example, the Treasury Department should revise what I understand is its current policy with respect to IMF programs and their implications for the need for debtor countries to pay interest to American creditors. I have in mind its legal position on the case in Costa Rica a few years ago.

With respect to the low income, mainly sub-Saharan Africa debt-ridden countries, the fundamental situation is much bleaker and we need to strive to achieve a clean slate for at least a dozen of these countries.

I suggest that official creditors, including the multilateral development institutions, consider major rescheduling. That has not been done before by the multilateral institutions. But I see no compelling reason why the World Bank and some of the Arab multilateral funds should not reschedule with long grace periods where no feasible alternative is available.

If this is deemed to be too disruptive of the conventions of these institutions, then it seems to me the multilateral institutions have to be repaid on behalf of debtor countries.

The question is how is that going to be brought about?

SALE OF IMF GOLD

Here I would point out that the International Monetary Fund still holds a large amount of gold, which has a market value at current prices in excess of \$40 billion, and a book value on its own books on the order of about \$4 billion.

In other words, it has prospective capital gains of just under \$40 billion. A small fraction of this gold could be sold into the market and the capital gains could be used to clean up the books of the poorest developing countries with respect to their debts to the multilateral institutions, and especially to the International Monetary Fund itself.

This should not be done unconditionally, but in the context of an IMF program for each eligible country. But it is absurd for us to continue to pretend that, in the foreseeable future, countries that have been net debtors to the IMF for 12 to 20 years are going to be able to repay without great economic cost. We ought to give them a fresh start.

Selling IMF gold would be one way to do it, which does not involve direct access to new budgetary funds.

I would expect in conjunction with that, however, that the bilateral official claims on these countries might also be written down. The debts of these countries are overwhelmingly to governments and other agencies; commercial bank claims on these countries are small.

To sum up with respect to desirable legislation, I would insert something in the proposed legislation which would mandate the U.S. Treasury Department, in conjunction with its counterparts in other major countries, to launch a serious, operationally oriented study of managed exchange rates, target zones, reference rates, and the like.

I would urge that serious consideration be given to the sale of some IMF gold, the capital gains from which would be used to deal with debt problems in the poorest countries.

Not least, I urge strong support for Category 150 of the budget resolution. We are going to need IDA money in the near future; and we are going to need a sharp increase in the capital base of the World Bank. The United States has to play a leading role in bringing these two things about.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

Mr. DeVries.

STATEMENT OF RIMMER DeVRIES, MORGAN GUARANTY

Mr. DeVRIES. Thank you, Mr. Chairman.

Unlike my colleagues, I have no prepared statement. I am going to focus on the LDC debt from the microeconomic point of view.

My basic supposition is that the existing framework for the cooperative strategy in the LDC debt issue is the correct one, although there is a constant and maybe an urgent need to improve its execution. But while I do not see at a glance how to make it more successful, I think we do need improvement in the execution.

The Baker initiative had three legs. The first leg was to improve the external environment.

In the previous discussion Mr. Mulford said although there is a great deal of debt, he has always recognized that the LDC debt issue cannot be solved satisfactorily unless there is a healthy world economic situation among LDC creditors. There have to be more

exports. That is the key because all the critical ratios are related to revenue from exports.

WORLD ECONOMY CONTINUES TO DETERIORATE

You have a set of tables in front of you that you might want to take a look at as I speak. In the last few years, including the years of the Baker initiative, the world economy has actually continued to deteriorate.

1984 was an excellent year, mainly because of very substantial American growth, but Japan also grew 5 percent in 1984 and Europe 2.5 percent. Since 1984 the world economy has gone downhill.

The United States held its own at around 2.5 percent on average, but Japan has steadily gone down—4.7 percent in 1985, 2.5 percent in 1986, and we are forecasting 2.2 percent for this year.

Europe is not much different. We now are forecasting that the German economy may not grow much more than 1.5 percent this year, if that. Some people are even beginning to talk about 1 percent. It is distinctly less than 2 percent, and I wouldn't be surprised if the numbers here are reduced further.

It is interesting that this weakening in the world economic market occurred at a time of substantially declining oil prices, which were supposed to be a major shot in the arm, as well as lower interest rates.

In the next table you can see that there has been no improvement in the exports of the 10 most important LDC's, particularly the nonoil countries. In the table, they are shown as imports of industrial countries from the LDCs because we have better statistics on industrial countries imports than on the debtor country exports. We see that the exports of the five leading nonoil LDCs to the United States, Japan, and Europe have remained absolutely flat from 1984 through 1986.

There was a substantial pickup of exports by these countries to the United States in the years before 1984, but there has been no change in exports of those countries to Japan and very, very little growth into the EEC. The United States was the only country that substantially increased imports from those countries.

Table 4 shows the exports of the three largest debtors—Argentina, Brazil, and Mexico—and their total exports. Again, 1984 was a good year. They all showed substantial export growth. 1985 was a disaster and 1986 was even more of a disaster, partly because of oil, as in Mexico, but even for Brazil and Argentina. All the LDCs showed substantial declines in export revenues.

No scheme on the debt can make any headway if there is not steady growth in exports of those countries to the industrial countries. A good rule of thumb is that the rate of the increase in exports should equal if not exceed the rate of interest. In other words, if the interest rate is 6 percent, debtor countries should have export growth of at least 6 percent if they have a trade balance of zero.

And of course to make real headway in improving the debt/export ratios, exports should grow faster than the rate of interest, say, 10 to 15 percent.

Now, not only is the world economy lackluster, as my predecessors have mentioned, and actually deteriorating, we are also facing the need to reduce the trade deficit of this country further in the next couple of years. Some of us think that we need at least an additional \$50 billion improvement in the trade deficit beyond what is presently forecast by most analysts.

If policies remain the same in the world, this reduction in the U.S. trade deficit will pose an additional deflationary burden on the world. That is why I think forecasts for 1988-89 are, at the moment, very speculative. We always start out with better assumptions and a little pickup in growth but we knock them down every month.

POSSIBLE RECESSION IN JAPAN AND EUROPE

Now, the fact, as I think Professor Cooper has indicated—he is not the only one—is that because of the weak world environment we should put a hold on making further improvements in the U.S. trade deficit right now. Otherwise we will induce a recession in Japan and maybe Europe.

The approach to this is a matter of judgment. Europeans and Japanese are torn and divided about what to do, and any excuse that might discourage dollar depreciation at this moment would relieve pressures on those countries to reflate. My attitude is let's absolutely not let up the pressure on them to reflate their economies.

It is now a month since the G5 communique. What do we see?

We see further delays by the Japanese on the budget that was supposed to have been approved by now. My own staff reports from Tokyo that it won't be done until early May, and the tax reform, which was neutral at best, may not even be passed because of internal political struggles.

The Germans are willing to do something, as you have indicated and I have heard earlier, but only in response to a much weaker economy than they had expected a few months ago, not because of a change of heart.

I feel that obviously they will do something, but what is a matter of political judgment. I think in this case the hard reality of the marketplace rather than diplomatic exhortations is going to make the difference.

At this stage I would not let anybody off the hook. I would encourage the Congress to keep pressure on the Treasury and the Federal Reserve to get on with improving the trade deficit in an environmental growth, without the jeopardy of a recession. I would encourage the Treasury and the Federal Reserve not to relieve pressure on the Japanese and the Europeans by any premature arrangements.

Now, what can we do?

As I mentioned to you on Friday in a another hearing, I would simply proceed alone at this stage while leaving the door open for working together with other countries in the various fora. We should move on the budget deficit. I think the Rostenkowski suggestion of 50/50, with some modest tax increases on gasoline, tobacco, and alcohol on a quid pro quo basis, with real cuts in spending, is an excellent one.

But it also takes away any basis for other countries to say "it is your problem, you do something." We have to do something first. Then we can work more effectively with them.

REDUCE INTEREST RATES

Second, we ought to reduce interest rates. We should not forget that cutting the budget deficit is going to be deflationary and we should be able to maintain a 2 to 2.5 percent rate of growth in this country. We also need lower interest rates as we move on with the budget deficit, and if the dollar slides a lot further, so be it. I think that would be a natural result.

I think exchange stabilization is basically premature at this stage if we keep the pressures on our counterparts overseas to get on with policy changes. But I will admit it is a matter of judgment and maybe of psychological makeup.

I mention these things because we are dealing with: (A) world economic growth, including the export markets of the LDCs, and (B) interest rates. Those, along with the debt issue, are the two key concepts with which we are concerned.

As I said earlier, the rate of export growth should exceed the rate of interest. If we can improve the external environment and improve the exports and at the same time lower interest rates in the industrial countries, that ratio will improve.

Now, the second leg of the Baker initiative is what I call self-help; structural adjustments by the debtor nations. I could talk a great deal about this, but I am not going to, except to say that I find what is happening in Mexico, the Philippines, Chile, Colombia, Argentina, Nigeria you would be quite pleasantly surprised.

I am impressed with progress in about six or seven areas where they are focusing on making structural adjustments: trade reform, financial market reform, more realistic interest rates, more market-related interest rates, improvement of the efficiency of state enterprises, debt equity swaps, maybe sometimes denationalization, and more foreign investment.

Most countries have made progress in two or three of these areas, but only over the past year.

Finally put it to you that the environment in most of those countries is very positive. They want to make changes. They want to improve. They know that state enterprises are overstaffed and inefficient. They are not making progress in all the areas—most of the time they are not doing enough on privatization and encouraging foreign investments—but they are making improvements in many of the other areas.

I cannot tell them what more they have to do. We obviously have to encourage them to continue on this path.

The one exception, of course, is Brazil, and Brazil is a very special case. It is almost a fallen angel because the country was the strongest—it had the greatest expectations, and could have come to the market. Basically Brazil's problems are internal political ones. I don't want to go into this, but the problems are in leadership and party squabbling. They have to straighten that out before they can really get on with policy changes.

But even in Brazil, the situation is not all bleak. They have taken quite a number of measures in recent months. Certainly exchange rates and interest rates have become more realistic.

The third leg is the lending, and I want to make a few comments on that.

As you remember, the Baker initiative objective was that the commercial banks lend to the Baker's dozen, which happened to be 15 countries, say \$20 billion over 15 years, and the World Bank was also to commit \$20 billion over 15 years.

I have great doubts whether those dollars will be released in those few years. We might see about half of what is envisaged in the Baker initiative, but so we have seen fairly little. I think we will have great difficulty in reaching even the limited objectives stated in the Baker initiative.

DATA FOR 10 MAJOR DEBTORS

Let's look at some data. We have collected data for 10 major debtors. IMF net lending has come down on an annual average basis from \$4.5 billion in 1983-84, to \$1.6 billion in 1985, to less than half a billion dollars in 1986. In 1987-88 we expect repayments by these 10 needy debtors to be \$5.5 billion. The undrawn balances under existing arrangements are \$4.5 billion. Assuming all these undrawn balances will be drawn and no new commitments are made, the fund will take \$1 billion of resources out of these countries.

Now, the World Bank and the IADB have gone up from \$3.2 billion per year during 1983-85 to \$4 billion in 1986. This did not compensate for the reduction in Fund lending. The commercial banks increased their lending to these 10 countries by \$5.5 billion in 1983-84 on a per annum basis, but in 1985-86, with some adjustments, basically they made no new net loans to those countries. Actually, because of charges, lending declined.

So we have a problem with two issues.

One is how to expedite and streamline lending. The second is how to increase actual lending?

I think it is high time, now that Mexico is behind us, or basically behind us, the heads of the major lending institutions—the Fund, the World Bank, and some of the commercial banks get together and iron out the technical issues. That should be done under the Baker initiative.

First, as you know, there are an incredible number of banks around the world involved in the negotiations. Take the case of Argentina. There are 335 banks involved in negotiating with the Argentines. Two-thirds of these 335 make less than 10 percent of the loans. 100 banks of the 335 make up 92 percent of the total loans outstanding for the country. So, about 250 banks, most of them there because of incidentals in trade financing and special deals, in the late 1970s or early 1980s, basically do not have any long-term interest in continuing to lend to most of these countries.

What we call exit bonds is a way out for those banks. I don't want to go into technical detail, but there are ways those banks can be bailed out. Well, they should be given an opportunity to discontinue lending to those countries.

Senator SARBANES. Mr. DeVries, if you could summarize these points, it would be helpful.

COFINANCING WITH WORLD BANK

Mr. DEVRIES. Reducing the number of banks involved would immensely facilitate the negotiations. There are banks that sold out their positions, but are required to keep on lending, because in 1982, they had loans outstanding. The old loan base ought to be updated. The banks ought to have different opportunities and options. I think Peter Kenen mentioned this. Some banks, when required to lend, lend in cash. Other banks may say, "Well, I would rather not increase my exposure, but I would be perfectly willing to forego for a year, interest payments on my present exposure." It amounts to the same thing: cash flow for the borrowing country, but it may be advantageous to the bank, from its own management point of view.

Many banks find it better to work with the World Bank. It is purposeful lending. There seems to be some comfort attached to it. I think there has to be more imaginative cofinancing with the World Bank. I think this also is the time, indeed, to talk about locking in lower interest rates. There should be a role for the Fund and perhaps the World Bank to play in assuming part of the interest rate risks of the debt. This could be done through interest rate swaps.

Second, I think it is terribly important that the Fund recognize that the debt crisis is a long-term one and not a short-term problem, and there should be no net reimbursements to the Fund at this stage. It is not the time for the commercial banks to provide money to the debtor countries so they can repay the Fund. It is not. It should not be done at this time.

Third, the banks ought to be involved in negotiations at a much earlier stage. What has happened, both with Mexico and Argentina is that the Washington institutions negotiated with the borrower, came up with a package, and dictated to the banks what they should do. We are not involved early enough in the negotiations. We only have jurisdiction over terms. We should be involved much earlier.

There is plenty to do. I will mention only a couple of things for the World Bank. Clearly, more imaginative and greater lending can be done.

Mr. Chairman, I am suggesting that the existing framework of cooperation be continued. Unilateral action, protectionism, and forcing the banks to do certain things, are not the way to go. But there are many ways that the existing strategy can be improved and facilitated in a cooperative way. Thank you.

Senator SARBANES. Thank you very much.

[The complete prepared statement of Rimmer DeVries follows:]

The Pitfalls of Target Zones

Additional statement by

Rimmer de Vries

Exchange rate target zones are open to a number of serious objections: they are hard to compute, in terms of assuring predictable impact on trade balances and the world economy; they may lack market credibility and thus require support by capital controls or sacrifice of national monetary independence; they can politicize economic problems; and they do not automatically assure better coordination of macroeconomic policies internationally, arguably reducing the already feeble pressures for adjustment by surplus countries and thereby increasing the danger of a world recession.

Exchange rate targets depend crucially on assumptions about economic objectives -- for example, the proper pattern of current account balances among nations, the acceptable inflation rates for the major countries and the world economy as a whole, and the desired rates of economic growth. However much one might wish it otherwise, governments in practice disagree among themselves, and often within themselves, about macro objectives, rendering the computation of appropriate exchange rates difficult at best. Even if there were a sufficient measure of agreement about objectives, the calculation of consistent exchange rates would remain a highly uncertain art. After all, economists cannot pretend to any great precision in their estimates of economic responses to exchange rate changes. Thus successive estimates of "equilibrium" exchange rates for the dollar computed by the Institute for International Economics

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(IIE), a prominent proponent of currency target zones, have been subject to repeated downward revision. Morgan's less formal estimates have displayed a similar tendency. The truth is that most analysts were surprised by the failure of the U.S. trade deficit to narrow in 1986 in response to the dollar's decline that began in early 1985. With hindsight, it is clear that expectations for foreign economic growth were pitched too high, and it is further arguable that the depressed state of the world economy inhibited adjustment of international trade flows to a more severe extent than historical relationships would have indicated. Besides, there are profound structural changes under way throughout the world economy, most conspicuously affecting petroleum, agriculture, and other commodities but also manifest in growing overcapacity in manufacturing (thanks in part to the rise of the Asian NICs). The price and exchange rate implications of these changes cannot be reliably factored into equilibrium exchange rate calculations.

International capital flows likewise are problematic for the computation of viable and constructive exchange rate target zones. John Williamson, in his work at the IIE, has employed substantially normative notions of "appropriate" capital flows in computing equilibrium exchange rates, their "sustainability" being rationalized largely from experience in the 1960s and 1970s. Yet, at the best of times actual capital flows are difficult to predict, the more so given

today's globalization of capital markets and increased capital mobility among nations.

It is a fact of life that market assessments of government policies and economic performance may or may not conform to official views or hopes. Heavy capital movements sometimes result that would swamp exchange rate targets unless counteracted by what might need to be drastic monetary measures at the expense of domestic goals and independence. In practice, the independence issue is pretty much illusory. Thus the history of floating exchange rates over the past ten years suggests that they offer little genuine independence for national monetary policies. More seriously, it is an open question whether a target zone system could be made to work without pervasive capital controls. The "success" of the Bretton Woods System in maintaining (mostly) fixed exchange rates during the first twenty-five years of the postwar period relied in no small measure upon a lattice of capital and exchange controls. Increased international capital mobility was one of the main signatures on the death warrant for fixed exchange rates in the early 1970s. More recent developments in market globalization, technology, and communications suggest it now would be flatly infeasible to institute capital controls of such effectiveness as would permit resurrection of fixed exchange rates or a tight target zone system in the foreseeable future. Of course, capital controls, like trade



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controls, carry heavy economic costs, whether or not effective to their professed purposes.

Another problem with target zones is that they threaten unnecessary and harmful politicization of exchange rate issues. Not only do target zones inspire conflicts between nations about appropriate exchange rate levels, but they politicize domestic decisions affecting the relative prospects of subsectors of each national economy. With target zones, industries subject to international competition have a strong and visible target for lobbying efforts to secure exchange rate levels that will optimize their own prospects. For the United States, there also is the problem that narrow economic interests may conflict with geopolitical and strategic goals. For example, while economically justifiable, a major further fall in the dollar in conjunction with continued German and Japanese unwillingness to adopt consciously expansionary fiscal policies risks full-blown recession in these countries with attendant strain on our political relations with these allies. At least as worrying, recession in the industrial countries would gravely exacerbate the political and economic difficulties of LDCs.

Under floating exchange rates, inconsistencies among national macroeconomic goals do not surface as debilitating Bretton Woods-style exchange crises but instead induce exchange rate changes that can have profound effects on real economic activity and inflation. Thus, experience has shown

that floating exchange rates may offer some limited freedom of maneuver in pursuing domestic policy goals but do not eliminate the need for the international coordination of macroeconomic policies. Target zone enthusiasts claim their system would step up and crystallize the pressures for effective coordination.

But happy results are by no means assured. Take, for example, the major issue facing the world economy today -- how to reduce the U.S. trade deficit without pushing the world economy into a recession. The answer can be found only in a balanced approach featuring more expansionary policies on the part of surplus countries. Otherwise, U.S. attempts to correct its external imbalance inevitably will lead to world recession. Unfortunately, target zones provide no clear incentive for positive adjustment by surplus countries and may even delay it insofar as they stifle the exchange rate appreciation that would otherwise inspire demands for domestic expansion. So long as the surplus countries remain wedded to outmoded mercantilist objectives externally and to demand restraint internally, as is the case now with Germany and Japan who are following low inflation and tight fiscal policy goals, other countries -- including the United States -- will have to adjust their economic policies to these restrictive goals or else allow their exchange rates to change. Stabilizing exchange rates at today's levels, whether or not under the formal banner of a target zone system, is prone to involve upward pressure on

Senator SARBANES. Gentlemen, in the Joint Economic Committee Report for this year, there are a couple of tables. This is the trade deficit table, and this is 1982 and this is 1986. You are all familiar with that movement. And this, in a sense, in many respects, is a logical consequence of that, is the net asset position of the United States. So we have gone from being a creditor nation here to being a significant debtor nation here.

Now the question I want to put to you. I look at these things with a growing sense of alarm and emergency. How serious is it? What are the long-term implications of this on the standard of living? My perception, of course, is that in the future, to meet the charges on this deterioration and that asset position, our people, in effect, are going to have to earn more than their standard of living, in order to make the payments.

So what are the long-run implications and how serious is this?

POSSIBLE $\$ \frac{1}{2}$ TRILLION DEBT

Mr. BERGSTEN. I could say two or three things about it. I think our approximate objective needs to be to stop the build-up of our net debtor position as quickly as we can. At best, that is going to take 4 or 5 years, and by that time, the net debt will be $\$ \frac{1}{2}$ trillion or so. But that's got to be the first objective—to stop it's getting worse. To do that, we have to sharply, of course, reduce the current trade deficit. Indeed, we have to shift over to a merchandise trade surplus that would be roughly equal to our net interest payments. I calculate the necessary turnaround in our trade position at about \$200 billion on an annual basis.

The deficit last year was \$150 billion. We will pay net interest of at least \$25 billion by the end of the decade. I think our oil import bills are going to go up again, because domestic production is down. Prices may rise, as well.

So as a rough approximation, we need a \$200 billion improvement from where we started over a period of 4 or 5 years. That means that for each of those years, our domestic output has to exceed our domestic absorption, consumption plus investment, by roughly 1 percent or 1.5 percent a year. It does not mean we have to go into recession. Indeed, we have to keep our output growing to hopefully meet the demand from abroad for our products and improve our foreign trade balance, but it means a reversal of the situation we had the last 5 years. Over the last 5 years, we've been consuming and investing substantially more than we produce.

That is the definition of the trade deficit and the capital in-flow. I am fond of saying that we now know the miracle of supply-side economics. The foreigners supply the goods and the foreigners supply most of the money. As a result, we have lived higher on the hog than our domestic production could permit. Now it has to go into reverse.

So we have to be producing for consumption abroad, accepting a much lower growth in our domestic absorption, maybe at best, 2 percent a year, against GNP growth of 3 percent, whereas it's been domestic absorption of 4 percent versus GNP growth of 3 percent, just in rough terms.

But we must accept a decline in our annual rate of domestic absorption. From that flow lots of other things, but let's make that as our first key element.

The second, I think, when we have the big foreign debt, as an economy and even in foreign policy terms, we will be increasingly vulnerable to decisions made abroad. We already see our financial authorities concerned about the reaction of foreign investors to individual Treasury bill auctions. That vulnerability will inherently be greater in the future.

I don't think it will be a steady threat to us, because, if we can get our own house in order and get our external accounts in balance in a steady state, I don't think there will be great long-term pressure. But every country gets out of whack from time to time, and when that happens, the existence of a huge foreign debt means that the risk of moving out of dollars, pressure on the domestic economy, even pressure on our foreign policy, is considerably increased.

Mr. COOPER. I agree strongly with Bergsten's first point. It is serious and it has to be turned around. If you think that 1986 was the turning point, and if one were to take that chart that you showed us and just reverse it, it would be 1991 by the time we are back in balance, and in the meantime, we will have accumulated a \$700 billion worsening in our net asset position.

The real problem, which Bergsten didn't emphasize, was that we have not been investing those funds. Our investment behavior in this economy has been more or less on its historical track. That is to say, the share of gross investment to GNP has been about what it is normally. 1984 was a good year. 1982 was a terrible year. 1986 was mediocre. But the relationship is more or less what it has been. If we had been investing these funds, we would have enlarged output to help service them. Net debtor positions are not per se bad. Canada has a huge net debtor position and nobody even thinks about it. It has been borrowing for most of its 120 years of existence, but it's been investing its borrowing productively. It has no trouble servicing the debt.

Our problem is that we have been engaging in public and private consumption rather than investing these funds. It means, therefore, that Americans in the 1990's are going to be about \$70 billion per annum less well off than they would otherwise be, because they are going to have to be servicing this debt. And of course unless we turn the situation around soon, the debt-servicing requirements could be vastly larger.

I do not agree with Bergsten's second point, that this debt makes us much more vulnerable to foreigners. I believe we are much more vulnerable today and will be even more vulnerable in the future to external events, but it is not because we have a large external debt. It is because we are much more open, in general, to the world economy, in particular to world financial markets. Often it is Americans, not foreigners, who are the most skittish about developments in the United States, and the most ready to move their funds abroad.

The fact that the claims are held by foreigners rather than Americans, therefore, does not add measurably to our vulnerability

to external events. That is intrinsic in the way our economy has grown and interacted with the rest of the world.

Senator SARBANES. Let me defer to Senator Graham. Then I will come back with some questions at the end. He has been very patient.

Senator GRAHAM. Thank you, Mr. Chairman. In light of the time, I would like to limit my questions to a narrow focus, subjectwise, and in terms of geography. Professor Cooper, I am sorry that I missed your statement, but I understand that you made some recommendations for a sell-off of IMF assets, in order to apply the proceeds to debt relief for some of the poorest sub-Saharan countries.

DEBT RELIEF FOR CENTRAL AMERICA COUNTRIES

Do you have any suggestions relative to debt relief for the similarly situated poorer countries in Central America, which have not been a major component of Secretary Baker's plan for debt relief, and which have had limited or no access to credit markets.

Mr. COOPER. No, I don't. I put them in different categories, because apart from Haiti, which is a very poor country, the Central America countries are all very well-to-do by sub-Saharan African standards—not, of course, by the standards of North America or Europe. But by the standards of sub-Saharan Africa, they are all very rich countries.

Second, I can't speak confidently about all, but for some that I know—Panama, Costa Rica, and the Dominican Republic—a substantial part of their debt is to commercial banks, whereas the debt of the sub-Saharan African countries is fundamentally different, being to governments and multilateral institutions and that lends itself to a different kind of solution.

I should emphasize that a small portion of the IMF's gold would take care of a lot of the problems of the sub-Saharan African countries. And I didn't mean to limit it to sub-Saharan Africa. There are other poor countries that have serious debt problems, but they are mostly in sub-Saharan Africa.

Senator SARBANES. How do you stay off that slippery slope once you get on it? I mean, what you are, in effect, saying is—if you will let me interject—we are going to take these countries and go this way and then all the other countries are going to be held, in effect, to the current arrangement. It seems to me there is enormous pressure to keep wanting to get over it into that other category. It would seem to me to make more sense to try to have a concept that deals with all of these countries. That way you don't need differentiations.

Mr. COOPER. There is no question about it, that one of the stymieing features of today's world is that while we insist, rightly in my view, that we have a case-by-case approach to these debt problems, in fact, every case is seen as a precedent. Depending on whether you are a creditor or a debtor, you choose the precedential aspect for all the rest, and there is no doubt that there is a slippery slope problem.

On the other hand, it is intrinsic, in a case-by-case approach, that we differentiate among countries and take into account important

differences. I would have thought that there are important differences, in terms of level of income, rate of decline of per capita income, nature of creditor. Those are three important differences which permit one to differentiate among countries. A simple line, just because it already exists, would be IDA line. Certain countries are eligible for IDA loans. Certain countries are not. It happens to be mostly African countries, plus a few Asian countries, who do not have debt problems, and a couple of Latin American countries that might qualify.

One could reduce the list of eligible countries by requiring that per capita income has fallen over the last 5 years, for example, in addition to a low level income, and then live with the consequences. We would have made some distinctions, but after all, we do make distinctions all of the time.

HIGHER STANDARDS FOR CENTRAL AMERICA

Senator GRAHAM. Returning to Central America, there is a feeling among governmental and business leadership in those countries that they are being held to a higher standard of debt renegotiation and consideration of their circumstances than, for instance, Mexico and Brazil, because of their relatively small scale, that they haven't had the attention that larger nations had. I don't know what economist it was who said, if I owe you \$100, I've got a problem. If I owe you \$1 million, you've got a problem. I think we are seeing an application of that theory.

Do you believe that the Central Americans have a legitimate cost of discriminatory treatment vis-a-vis other larger debtor nations, and if they have a legitimate beef, do you have recommendations as to what the U.S. governmental policy should be in that region to redress them?

Mr. COOPER. I don't have the basis to compare whether, for example, Costa Rica, which is a relatively debt-ridden country, which we attach some importance to, has been treated more or less equally or impartially, say, with Mexico.

I can believe that the charge has some merit, if only for this reason, that the larger debtors are big enough to engage the attention of the U.S. Secretary of the Treasury, the Chairman of the Federal Reserve, and so on, Senior officials have a limited amount of time to lean on banks to put together a package.

Smaller countries, I would conjecture, get less attention. Whether that translates into more or less disadvantageous deals, I don't have a basis for comparison.

Mr. BERGSTEN. If I could just add one note. There is another side to the question. Less also has virtues in this context because you can get away with more being small.

At least two of the Central American countries, including Costa Rica, have really been not paying much of their interest for a number of years.

Arrears have built up. But, because it is small, the banks don't worry about it as much as they would if it were Brazil or Mexico.

So it's true on the one hand they don't get the kind of attention and the big rescue packages.

On the other hand, they can slip through the cracks better. How it nets out, I'm not sure. But there is that other dimension to the issue. That's empirically verifiable.

Mr. COOPER. That's a valid point. Just to underline it, Ecuador announced, 2 or 3 weeks before Brazil did—this was before the earthquake—that it could not service its debts. It did not make front-page news. When Brazil announced the same thing it did make front-page news.

Mr. BERGSTEN. And Ecuador is huge compared with some of the Central American countries in terms of the debt level.

Senator GRAHAM. Professor Kenen.

Mr. KENEN. Senator, I have been glancing at the bible for those who play this game, the *World Debt Tables*. I am struck by the fact that, for most of the countries of Central American bank debt is not as large relative to total debt, as Richard Cooper suggested. With the exception of Costa Rica, debt to official institutions accounts for upward of 70 percent of the total debt of those countries.

The distinguishing characteristic of these countries is the other one that Professor Cooper mentioned. Their income levels are vastly higher than those of sub-Saharan Africa.

If a dividing line has to be drawn, surely, the case of sub-Saharan Africa stands out as one that calls for collective action by the international community on a scale and in a manner different from almost any other instance.

Senator SARBANES. Let me just put a couple of questions in and get some very short answers. First of all, in order to get a broader perspective, do you disagree with the point that it would be reasonable for the United States, since it is carrying much more of a security burden, to factor that into the deals with other strong economies that are part of the security umbrella—Germany, Japan—in terms of the contribution we think they should make toward their growing world or international economy?

Mr. COOPER. Senator, I do not agree with that point. I can understand its attraction from a debating point of view. But I think it's worth recalling that our level of defense spending is determined unilaterally and we recently increased it sharply unilaterally. For us to take those decisions on a unilateral basis and then turn around and tell the rest of the world that because we are bearing so much of the defense burden they have to chip in more, I think will not be taken well.

Senator SARBANES. I think that's a reasonable point if the spread weren't as great. But, even if we had not made such—suppose we were at 4.5 percent instead of 6.5 percent? Japan would still be at 1 percent.

Mr. COOPER. On a comparable basis, over 1.5 percent. But I take your point. The Europeans are much closer to where we were 6 or 7 years ago, but still somewhat below.

Senator SARBANES. I accept that modification. But, given that, is it still reasonable to say to Japan in this instance, well, you've got this now. We're not pressing you to become a military power.

Actually, some of our people are taking that approach, pressuring them to become a military nation. I tend to regard that as a mistake.

On the other hand, say, well, your economy is of such strength, you've got to assume this has got to be factored in when we look at the kind of international economic contributions of Japan.

Mr. COOPER. Put in its most general way, I would certainly agree. The approach that's been taken to Japan on the military side has been a task-oriented one—improved air defense and anti-submarine capability—rather than focusing on the level of spending per se. And that is the correct approach, in my judgment.

They can spend more on defense, which is complementary to what we spend, but we should certainly not push them into general remilitarization. Instead, we should emphasize their global responsibilities. The Japanese themselves have a concept of comprehensive security which encompasses economic and diplomatic policies as well as military spending. We should build on the Japanese concept of comprehensive security and urge on them more responsibility in the economic area.

Japan is now launching its third aid-doubling program, to be sure, from a low level, but they now spend more on foreign aid relative to their GNP than the United States does. We should be sure the aid-doubling is measured in yen rather than dollars.

Senator SARBANES. You've all talked about the responsibility of Germany and Japan to reflate their own economies as a contribution toward the world economic order.

What about the responsibility to help deflate the economies of the developing world?

ECONOMIES OF DEVELOPING WORLD

Mr. BERGSTEN. I think the most effective thing they could do to promote growth in the developing world is to promote more rapid growth of their own economies, because that then creates the market expansion into which the developing countries can sell.

I know what you're thinking of in terms of capital flows, but I think the only lasting solution to any of this Third World debt problem or, indeed, to getting growth going again in the developing world, is export-led growth.

That requires two things: Open markets abroad, that is, no protectionism; and it requires growth of demand in the economies of the major markets.

So I would put most of my effort, not just for U.S. reasons but for exactly the reasons you have in mind, on pushing the Japanese and the Europeans to expand the growth in their domestic economies.

I want to refer in that context to a point you made with Secretary Mulford. You were expressing doubt, and he tended to agree, that economic growth expansion in the other industrial countries would not really mean much for our trade balance. I'm more optimistic than that.

I have a fairly ambitious target in mind. Japan and Western Europe, led by Germany, ought to be taking measures to expand domestic demand growth in their economy by at least 2 percentage points a year for at least the next couple of years.

If you do that, and using the Federal Reserve's model of how these things work out, U.S. exports at the end of the period will be something like \$40 billion a year higher.

Part of that, and an important part, is not because we will sell more to Japan or Germany directly, but because their expansion will pick up the world economy, including the developing countries, let them export more and let them in turn buy more from us.

So the proverbial rising of all boats in the sea could be encouraged by that kind of measure. And that's really where I would put my emphasis, given the fact that I think it's terribly important to get these deficits down rather than to find clever new ways of financing them.

Mr. KENEN. Senator, I agree with everything that's been said. I would just add one note. The United States has taken a much larger percentage of the growth in the exports of manufactures from the developing countries. Europe and Japan are far behind.

Now, whether this represents systematic protection on the part of the European and Japanese governments against goods produced by the newly industrializing countries, whether it represents the influence of opaque private-sector arrangements that we do not fully understand, or whether it represents the tastes of Japanese consumers, I do not know.

But the matter deserves very close inspection. In most of our discussions with the Japanese, we have concentrated on their treatment of our goods, but we are not alone. The countries of Southeast Asia complain bitterly about Japanese barriers to their goods. And we would probably hear similar complaints if we talked to Latin American businessmen trying to ship to Japan and Europe.

If the economic expansion that Fred Bergsten was discussing is going to help the developing countries, it is terribly important that the Japanese and Europeans not put new trade barriers in place. They must, indeed, dismantle existing barriers that discriminate against the exports of the developing countries.

Senator SARBANES. There's a chart in the Joint Economic Committee Report: Latin American exports to the United States, Japan, and Germany. This index is 1965 here, 1985 here. This is Japan and Germany, these lines. This is the United States, which of course makes that point just for the Latin Americans.

Mr. COOPER. Could I also reinforce what Fred Bergsten said? I strongly agree with him on this point.

There's a tendency now, especially in Europe, to denigrate the influence of European growth on U.S. exports. They take the narrow impact of European growth on U.S. exports.

There is the third country effect, which Bergsten described, but there's also the terms of trade effect.

One of the difficulties of the LDC's at the present time is that they have experienced a sharp deterioration in their terms of trade. Much of it is due to the fact of the very low growth in the world. And to the extent that the Europeans and Japanese, both of which are highly dependent on raw materials from around the world, increase their demand, that would improve the terms of trade and simultaneously help the debt problem. And help reduce the U.S. trade deficit by LDC's. So I agree with him that getting their growth up is the most important point. Just one further

point. I have suggested to the Japanese that they might think of some way to develop what I call LDC participation notes, in which they encourage some of their nonbank financial institutions to lend directly to developing countries with or without a Ministry of Finance guarantee.

It seems to me that could make a useful contribution in the current circumstances. What does not make an especially useful contribution is for Japan to lend to the IMF. By doing that Japan is acquiring a first-rate claim, and the IMF does not need the funds. I would not give Japan any credit for this action. But new loans to LDC's, united to Japanese exports, would be a great help.

Senator SARBANES. That brings me to the special facility. Why is it unreasonable to expect Japan and Germany, that are running these large current surpluses, to make a contribution to the special facility that in effect would reflect that fact?

It would not necessarily be solely related to the extent of their own bank's involvement or related to the strength of their overall economies, but would reflect this current situation.

Let me press that a little further. I'm hard put to see how we're going to get the Third World debt problem regularized and into some acceptable framework if we don't start thinking about the process whereby you develop what would be an overall multilateral strategic plan.

Now, at the moment, a couple of things are happening. Banks are taking the hit to some extent. They're selling off these loans. The debtor country gets no benefit out of that. The person picking it up is doing it for speculative purposes.

Second, the Baker Plan is not producing a flow of capital into these countries, and it's not hard to see why that happened and where it would come from.

Third, I think we're increasingly running the risk that this debt problem will be politicized. My perception is it's an open invitation to demagoguery and, to some extent, I'm surprised that more of that has not happened, rather than less.

I think that some of the large debtor countries are, in a sense, beginning to pick up on this, although they're not using extreme rhetoric.

But, the Brazilian situation now, it seems to me, is an extraordinarily serious predicament we're facing. I don't see how you're going to get \$150-200 billion turnaround in the U.S. trade merchandise position in a few years time, if not in the context of a lot of other things happening as well.

So, in a sense, I think you need a full court press. And part of that full court press would be, in effect, developing an economic strategy for countries that say, yeah, that makes sense. We're going to take these measures internally.

I was interested in some of the observations on the extent to which some of these countries are trying, and trying very hard, but we're doing it in a context where we can let out the sub-Saharan countries without establishing a precedent, since the other countries are going to be dealt with in another way.

Now, I think we need to come at it in that sense, in a more encompassing sense. Otherwise, things are going to run away from us.

Mr. COOPER. While I think what you say is absolutely right, the question is whether one can find an operational all-encompassing approach to this.

RELIEF FOR DEBTOR NATIONS

Where I stumble, and it may just reflect lack of creative imagination, is providing actual relief to debtors with respect to private debts. As you point out, a lot of the claimants have written their claims down on their own books and they've sometimes even sold them off into the market at a discount.

But that does not provide any relief at all for the debtor unless the debtor happens to be the purchaser. Of course some of the debt equity swaps, which a number of countries have introduced, are an indirect way of getting some relief to the debtor. That's a healthy development but it's not going to become really big money, in my judgment.

The plan Peter Kenen has proposed and which he referred to today has the great merit that it has the possibility of providing relief to the debtor on a case-by-case basis.

The difficulty is, I think, that it does so only by getting public backing for private claims. Far be it from us to make political judgments here about what will and will not overcome political hurdles, but I would hate to be put in the position of voting on legislation that involved public money to bail out public debtors whose own residents often have large amounts of funds abroad which are beyond the reach of the tax authorities of those countries themselves. It seems to me a very difficult thing for a Congressman or Senator to vote on unless some arrangement is made for returning at least a portion of the earnings on those overseas assets.

Senator SARBANES. If the banks took a hit on the discount, you would not be bailing the banks out in the sense of doing it at the level of 100 percent. Now, if the debt burden left—if the facility would assume a burden that would be serviced, it would not cost the taxpayers any money but would carry with it a potential cost?

Mr. COOPER. It carries a risk.

Senator SARBANES. It carries a risk that might in fact occur, and it would break you out of this mold of having American producers and American financial institutions at direct cross-purposes with one another.

We are going to hear from a panel next week, and I am fairly confident that what some of the producers will then say is that these policies, if pursued in developing countries in order to enable them to meet their financial obligations, would just deal a tremendous blow to American producers because what they have done is adopted austerity measures so they no longer take our exports. Furthermore, they become more intense competitors because they are seeking to maximize their exports to us.

So our producers face a policy that was instituted in these countries in order for them to meet their financial obligations, which in effect have very negative repercussions for American producers. Either they lose their export market or they face more intense competition because of the push for putting products into the American market.

Mr. DEVRIES. I would like to make a couple of minor observations here.

Many of the producers look back to, say, 1980 to 1982 as the normal years. But those were the years when we had unsustainable over-lending to Latin America. In the early 1980's we were exporting too much to these countries. They were over-borrowing and they were over-consuming.

Now, they have to learn the job of exporting. They will have to compete with the Koreans and the Taiwans, and some of the surpluses of those Asian countries will, I hope, in due course be switched to Mexico and other countries.

The numbers you have in front of you do indicate the situation is not hopeless. For instance, this year all the key Latin American countries are going to show modest growth.

There is a normalization going on in Latin America. Brazil has had an extremely high rate of growth in the last couple of years, after really over-consuming, and I think they have become normalized. Argentina, Brazil, and Mexico all are going to have about a 3-percent rate of growth.

The oil prices coming back from the \$9 to \$10 area to the \$18 area is a major boost to most of the Latin American countries, with the exception, of course, of Brazil, but Brazil has also found increasing oil, offshore particularly. The normalization of oil prices is a major boon to the Mexican economy.

As to Peter's plan, the banks have been doing a lot of things in the last few years. They have been selling some loans, particularly to Central America. I don't know what the numbers are, but I am sure that most American banks have very, very small positions in Central America and Africa, and even in such countries as Ecuador or Bolivia. Most of these loans have been sold. There have been a great many charge-offs over the last few years, and of course there has been a buildup of loan losses—I wouldn't call it massive, but very substantial—depending on the earnings of the banks and the bank management.

There is normalization going on. In fact, if I go back to my own earlier point, we are at the moment undershooting. The markets are always overshooting or undershooting. We have seen it in the exchange markets; we have seen it in the credit markets.

We were overshooting the credit markets in the late 1970's and early 1980's. We were lending, obviously, too much. We were encouraged by the officials to do so. We had to do recycling, and there was nothing else in place. It was the only game in town.

The banks had to do this. We were asked.

We are now in a period, I think, of undershooting, and that is why I am suggesting we have a menu, an agenda for ironing out a lot of technicalities to stop undershooting in the credit markets.

I find it interesting that Brazil came very close to coming to the market this year. Colombia is a country that should be able to come to the voluntary market.

FLIGHT CAPITAL

Right now we are in the process of a major bond issue for a Latin American country, a dollar bond issue. We have gotten the man-

U.S. interest rates; this would heighten the risks of recession and also, given that few objective analysts or market participants believe that present exchange rates are consistent with correction of the U.S. trade imbalance, shorten the odds on eventual dollar collapse.

Perhaps the most basic flaw in proposals for exchange rate target zones lies in their elevation of the exchange rate to the be-all-and-end-all of international economic management. In fact, the exchange rate is more constructively viewed as a residual or by-product of economic policies generally. The vital purpose of international management is to improve the performance of the global economy, with particular emphasis on economic growth, inflation, and trade or current account balances, bringing to bear the tools of macroeconomic policy exemplified in national fiscal and monetary postures. This is a short list of "objective" indicators that lend themselves to international monitoring, coordination, and goal-setting. In this broader context, assignment of overriding priority to currency stabilization makes little sense, since it inevitably places principal stress on international coordination of monetary policies: fiscal policy changes are difficult to implement in the short term and can be slow to yield their real economic and exchange market effects; however, even though short-term results are typically at a premium, it is foolish to neglect the longer-term benefits of positive fiscal policies to support

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demand in a sluggish world economy. Altogether, it must be hoped that future efforts to strengthen global economic management will avoid the myopic charms of currency targeting and instead confront the broader challenge implicit in the real economic content of the proposed objective indicators.



date, and we are going to place a sizable dollar bond issue, which is probably going to be subscribed mostly by residents of that country, which means returning flight capital,

It is interesting that the flight of capital from Latin America has pretty well dried up. Some capital has come back. In Mexico the amount is not massive, but the situation is a lot better. Instead of \$3 billion going out, maybe a billion dollars comes back.

It is part of the normalization. I think the interest rates, the real interest rates, have become very attractive in some of those countries, and I think the Mexicans particularly deserve a great deal of credit for coming out of a very difficult period of low oil prices and a disastrous earthquake. They have stuck to a consistent, quite conservative program that they may well be able to keep through the next elections, and so some money is coming back. Debt equity swaps are a way to attract money, particularly if they make them available to residents.

The Chileans have done it. The Chileans are reducing debt. The Mexicans are thinking of making these swaps available to Mexican residents, which means that more of the Mexican assets are going to be returned.

I find in all this, a malaise, a fatigue, as we call it, and yet there is quite a lot of normalization going on.

It is like Beirut. Half of Beirut is in ruins, and the other half of Beirut is still business as usual. There is business being done in Latin America.

It is not all currency business, but as I say, we are doing a bond issue, there is project financing going on, there is a desire to move on and to lend as well. I think the banks, the World Bank, and the IMF can make technical contributions this year to improve this lending pattern.

To me that is progress. Improvements can be made because you are dealing with relatively few people. It is not easy, but I think it is possible.

Sometime when you have technical bankers you may want to pursue some of these issues. I think they are quite promising.

I am not despondent. That is why I say I stick to the basic framework of the Baker initiative, even though none of the three legs is totally satisfactory. To lending I give the lowest mark, to external priorities the second lowest mark. We have to keep pressing on those issues, but let's keep the framework in place.

Mr. KENEN. Senator, there has been a great deal of discussion about the political realism of proposals like those that you and I have put forward. Dick Cooper has just referred to this issue. Let me mention one number which will put some of this in perspective.

Like Secretary Mulford, I did some calculations to see what a plan like your own or mine would involve, and one of my calculations went this way: Suppose that the banks brought forward half of their claims on the Baker countries and asked the new facility to discount them. Suppose that the average discount rate was 35 percent. How large a body of securities would the new agency have to issue to the banks, which in turn would define the upper limit of the obligation that the governments of the developed countries, including the United States, would have to assume as guarantors. I came out with a total of \$72 billion. This is the amount of debt that

the new agency would have to issue if it took up half the banks' claims on the Baker countries.

I don't know how successful we would be in persuading the Germans and Japanese to take up a large share of capital. But let us suppose that the United States took about one-quarter of the total. That would be \$18 billion. And this is its contingent obligation, not a recurrent or once-for-all cash outlay.

When we talk about the very large numbers involved in the debt problem, we tend to conclude erroneously that the corresponding remedies involve enormous amounts of money. They may not.

Let me also point out that it may not be necessary for the new institution to have a one-to-one ratio of capital to debt. The numbers are large, and I would be unhappy if they bumped the IDA replenishment, but they are not so very large as to stagger the imagination.

Mr. BERGSTEN. Just to put it in context, if Peter's number is right, that would be considerably more than the U.S. would have to put up in the way of guarantees for a doubling of World Bank capital in a new general capital increase. So we are talking about substantial amounts of money relative to other items on the agenda.

Senator SARBANES. Well, politically if you are going to make it work, it is part of my proposal that the U.S. percentage would be less than that because that percentage corresponds to essentially what we give now, and so forth.

One of the arguments is that this is a special facility for a limited purpose and the other countries ought to make a bigger contribution. To the extent that the U.S. percentage is less than the U.S. percentage of the normal replenishments of either the World Bank or IDA it becomes helpful politically to try to carry this initiative because it is obviously then a better proposition from our point of view.

The sticking point is are the other countries prepared to ante up, and that depends, I think, on how it is put together and how they perceive it.

It also would avoid the voting rights question, which of course we like and they don't like. But it all proceeds off the beginning premise on my part that these countries are not carrying the full measure of their international economic responsibilities given the strength of their national economies, and we need in effect to call them on that.

They have to play a role in helping to create a growing and prosperous international economy. The notion that the U.S.—as is essentially the case throughout the postwar period—is going to be almost the sole actor trying to do that I think is long past.

Well, gentlemen, thank you very much. You have been a helpful panel, and we appreciate your time and your efforts.

[Whereupon, at 1:05 p.m., the subcommittee was adjourned.]

EXCHANGE RATES AND THIRD WORLD DEBT

WEDNESDAY, APRIL 1, 1987

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:35 a.m., in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Proxmire, Dixon, Graham, Heinz, and Gramm.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

This is the fifth in a series of hearings that this Subcommittee on International Finance and Monetary Policy has been holding in preparation for the consideration by the Banking Committee of relevant matters under its jurisdiction which will pertain to the trade bill which the Senate expects to take up in May or June.

The hearings this morning and tomorrow morning will focus on the issue of Third World debt. This morning we will be looking at the consequences of the Third World debt issue for the U.S. financial system and for trade and foreign policy questions. Tomorrow's hearing will examine some ideas for addressing the debt problems of the Third World and the regulatory and accounting rules within which any approach to the debt problem must function.

Obviously, recent developments—in particular, the action by Brazil with respect to its foreign borrowings—have served to remind us that the debt problem of the Third World countries are still very much with us. While some progress has been made, as for instance the recent signings of loan agreements for Mexico and the Philippines, it's clear that the matter continues to be on our agenda.

I am hopeful that we might begin to develop a structure within which not only the short-term but also the long-term debt problems of the developing countries can be addressed. It is clear that there is a very large debt overhang that creates the serious trade problems as well as, of course, the constantly recurring financial crisis with which we are confronted.

We hope from our witnesses this morning and also tomorrow morning to have shed some light on this problem. We are very pleased to have this panel with us. We will have two panels in succession this morning and before I call on the members of the panel to make their statements and then respond to questions, I turn to

Senator Proxmire and then Senator Heinz to see if they have anything they wish to add.

[The complete prepared statement of Senator Sarbanes follows:]

OPENING STATEMENT

SENATOR PAUL SARBANES

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

Hearing on Third World Debt

April 1, 1987

This is the fifth in a series of hearings the Subcommittee on International Finance and Monetary Policy is holding in preparation for the Banking Committee's consideration of the portion of the Senate trade bill which falls within its jurisdiction.

The hearings this morning and tomorrow will focus on the issue of third world debt. This morning's hearing will review the consequences of the third world debt issue for the U.S. financial system, trade, and foreign policy. Tomorrow's hearing will examine some ideas for addressing the debt problems of the third world, and the regulatory and accounting rules within which any approach to the debt problem must function.

The recent decision by Brazil with respect to its foreign borrowings has served to remind us that the debt problems of the third world countries, particularly in Latin America, are still very much with us. Significant progress has been made, as the recent signings of loan agreements for Mexico and the Philippines indicate. Yet the problems remain and seem to me as urgent as ever.

My concern is that we begin to develop a structure within which not only the short-term but also the long-term debt problems of the third world countries can be addressed. The fact is that the third world countries and the financial institutions from which they have borrowed have a huge debt overhang that will not go away. Loan packages that help individual countries get through immediate crises are important and necessary, but we must develop some way in which we can begin to deal with the larger long-run problem. The fact is that if we don't take action now at our own initiative, we may be forced to take much more drastic action in the future when a major crisis develops.

On that note, let us turn to our first witness, Mr. Guenther.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman.

First, I want to congratulate you on your diligence. This is the fifth hearing, as you point out, of your Subcommittee on international matters.

This hearing is especially timely and important. The fundamental question surrounding the international debt issue is whether it's a temporary liquidity problem or whether it's a matter of at least partial debtor insolvency. In a liquidity problem, a debtor may temporarily be strapped for cash but he can actually work himself out of his difficulties if banks make new loans to him. In a situation of insolvency, we recognize that at least some of the debt is bad and can never be repaid.

Does the market itself shed any light on the issue of whether we face a liquidity or an insolvency problem? I think it does. The Venezuelan debt, for example, is valued at 71 cents on the dollar; the Mexican debt is priced at 55 cents; Argentinian debt at 62 cents on the dollar. If this is what the market is telling us, why aren't the regulators forcing banks to recognize this reality by increasing their revenues against these loans?

Well, one reason is their concern that this would be inconsistent with the Baker plan which calls on the banks to make new loans as a means of keeping current loans as performing assets.

A major problem with not requiring the banks to recognize that they have at least a partial insolvency problem and reserving against it is that the banks get locked into a position of not being able to accept the fact that the real value of their loan portfolio is deteriorating. This, in turn, makes them less flexible in accepting approaches to the debt problem that may in the long term be in their best interests and our country's best interests and the best interests of the debtor nations.

It also strengthens the long-term safety of our banks if in fact the administration's liquidity analysis is wrong. That's why I am joining today with Senator Gramm to introduce the International Lending Institutions Safety Act of 1987. Senator Gramm may want to give more details on this bill when he speaks.

Let me just say that it is designed to force our banks over a period of years to build reserves against the market value of their loan portfolio. This can lead to greater bank safety and in time to an increased reliance on the market as a partial aid in solving the debt problem.

Mr. Chairman, I hope I can stay for a while. Unfortunately, I have to chair a subcommittee of the Appropriations Committee at 10 a.m. so I'm going to have to leave before we get really into the hearings, but I'm going to examine the transcript.

[The complete prepared statement of Senator Proxmire follows:]

OPENING STATEMENT OF
SENATOR WILLIAM PROXMIRE
HEARING ON INTERNATIONAL
DEBT

Mr. Chairman:

This is the fifth in a series of hearings your subcommittee has held to examine various international matters within the Banking Committee's jurisdiction. These hearings are in preparation for a mark up of legislation dealing with trade issues that will be conducted at the full Committee level in the latter part of April. Of course, the international debt problem is much more than a trade issue. The problem, as we will hear today, has significant moral, political and bank safety implications as well. But because the problem does impact America's trade position there will be an opportunity to at least partially address it in the context of the trade bill that the full Senate will take up later this spring or in the early summer. So this hearing is timely and important.

As I have said before the fundamental question surrounding the international debt issue is whether it's a temporary liquidity problem or whether it's a matter of at least partial debtor insolvency. How we answer that question will determine our approach to seeking a solution. In a liquidity problem a debtor may temporarily be strapped for cash, but can actually work himself out of his difficulties if banks make new loans to him. In a situation of insolvency, recognition must be given to the fact that at least some of the debt is bad and can never be repaid. The Reagan Administration has since 1982 analyzed the debt issue as a liquidity problem. This is why Secretary Baker continues to call on our commercial banks to make even more loans to the debtor nations. Many of the less exposed banks are reluctant to do so because they disagree with the Administration's analysis. These banks are willing to take their losses on past loans and believe they should not make new loans. The larger money center banks, whether they really believe they face only a liquidity problem, feel compelled to make new loans as they are not in a position to suffer major losses on the loans already made. They and the Administration pressure the regional and smaller banks to kick in more money with each new

renegotiated loan package. New lending to the debtor countries is in fact forced lending and not market lending.

Does the market itself shed any light on the issue of whether we face a liquidity or insolvency problem and whether the Administration's approach is correct? I believe it does. Press reports, such as the March 16 edition of Barron's, tell us that commercial debt is trading at various discounts off its face value. Venezuela's, for example is valued at 71 cents on the dollar, while Mexican debt is priced at 55 cents and Argentinian ~~debt~~ ^{Debt} at 62 cents on the dollar. If this is what the market is telling us, why aren't the regulators forcing banks to recognize this reality by increasing their revenues against these loans? One reason is their concern that this would be inconsistent with the Baker Plan which calls on the banks to make new loans as a means of keeping current loans as performing assets.

A major problem with not requiring the banks to recognize that they have at least a partial insolvency problem and reserving against it, is that the banks get locked into a position of not being able to accept the fact that the real value of their loan portfolio is deteriorating. This in turn makes them less flexible in accepting approaches to the debt problem that may, in the long term, be in their best interest, our

country's best interest, and in the best interest of the debtor nations. It also threatens the long term safety of our banks if in fact the Administration's liquidity analysis is wrong. That is why I am today joining with Senator Phil Gramm to introduce the International Lending Institution Safety Act of 1987.

Senator Gramm may want to give more details on this bill when he speaks. Let me just say that it is designed to force our banks over a period of years to build reserves against the market and not face values of their loan portfolios. This can lead to greater bank safety and in time to an increased reliance on the market as a partial aid in solving the debt problem.

I look forward to hearing from our distinguished witnesses.

Senator SARBANES. Very good. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. I join Senator Proxmire in commending you on these hearings. I also am pleased to be able to welcome one of my constituents, Charles Coltman, who is seated front and center.

I do commend you for your great attention as chairman of this subcommittee to such a wide range of issues in the international financial area and I would add that, as I've looked over your hearing list for the next week or two, the testimony should disabuse us of any notion that the debt problem is some kind of esoteric issue of interest only to editors of dusty academic journals.

I would observe that U.S. banks remain heavily exposed to international debt despite a major effort to build bank capital in recent years. Exposure to major debtor countries continues to exceed the aggregate capital of the nine largest U.S. banks. The \$86 billion of total U.S. bank exposure to these some 15 debtors represents both massive exposure and a serious drag on international trade.

U.S. trading interests have been badly hurt as our exports and our export industries have taken a beating in the 5 years since the start of the debt crisis. U.S. exports to Latin America remain today at a level 25 percent below that of 1981 and reduced export level represents roughly a quarter of a million jobs in U.S. export industries.

Mr. Chairman, I would ask unanimous consent that my entire statement be placed in the record, but I would conclude simply by saying that we not only have a problem, we have a problem in need of some solutions.

Heavy indebtedness is a symptom of economies allowed to get badly out of sync with the world economy. Correcting these basic problems, restoring U.S. export markets, and for that matter, dealing with the needs of the poor in the indebted countries, is primarily the responsibility of debtor governments. We must support their efforts and we cannot substitute for them. Nothing we can do with the stroke of a pen will resolve underlying problems or provide any more than very modest and temporary relief.

Now that's not to say that the Baker plan or current regulatory procedures are working flawlessly. They are not. I would agree with one witness who notes that current practices seem designed more to stifle innovation than to find solutions. Where debtors are at work on their problems, regulators must be as supportive as possible in efforts to reduce the debt burden, swap debt for equity, and promote greater reliance on private investment.

I would also like to think, Mr. Chairman, that we will also have a strong Export-Import Bank and foreign aid program to assist this process. But as we sit here, the Budget Committee of the Senate is even now crafting a budget that would eliminate Export-Import Bank loans and make deep cuts in U.S. aid.

Mr. Chairman, I must also observe that where countries do not come to grips with their problems—and there are some—no creditor plan will work and the regulators must ensure that U.S. banks recognize the possibility, unwelcome as they are, of losses.

Thank you.

Senator SARBANES. Thank you, Senator Heinz. Your full statement and Senator Dixon's statement will be included in the record. [The complete prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR HEINZ

Mr. Chairman, today's testimony should disabuse us of any notion that the debt problem is an esoteric issue of interest only to editors of dusty academic journals. International debt is a problem that adversely affects our financial institutions, our exporters, our political interests around the world, and the welfare of millions of people here and abroad.

U.S. banks remain heavily exposed to international debt, despite a major effort to build bank capital in recent years. Exposure to major debtors continues to exceed the aggregate capital of the nine largest U.S. banks. The \$86 billion of total U.S. bank exposure to these debtors represents massive exposure and a serious drag on international trade.

U.S. trading interests have been badly hurt as our exports and our export industries have taken a beating in the five years since the start of the debt crisis. U.S. exports to Latin America remain more than 25 percent below their level in 1981, and that reduced export level represents roughly a quarter-million jobs in U.S. export industries.

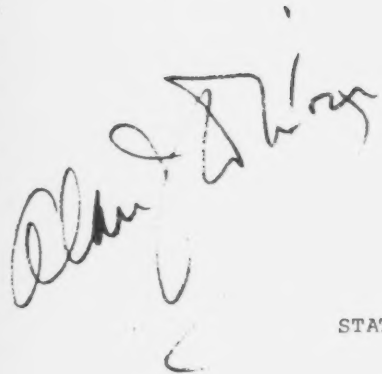
Looking at Latin America itself, the social fibre of newly democratic societies is strained as governments attempt to come to grips with past policy errors and current economic problems. National wealth has fled abroad and those least able to cope with economic dislocation have suffered.

So the problem of debt is very real. The question we face is what can be done about it. The answer, I am afraid, is that there are no grand solutions, and certainly no quick or easy ones. While it is perfectly normal to be dissatisfied with the slow pace of recovery, there is little reason to believe that more dramatic solutions can quickly resolve the debt problem.

Heavy indebtedness is a symptom of economies allowed to get badly out of synch with the world economy. Correcting these basic problems, restoring U.S. export markets, and for that matter dealing with the needs of the poor in the indebted countries is primarily the responsibility of debtor governments. We must support their efforts, but we cannot substitute for them. Nothing we can do at the stroke of a pen will resolve underlying problems or provide any more than very modest and temporary relief.

This is not to say that the Baker Plan or current regulatory procedures are working flawlessly. I would agree with one witness who notes that current practices seem designed more to stifle innovation than find solutions. Where debtors are at work on their problems, regulators must be as supportive as possible of efforts to reduce the debt burden, swap debt for equity, and promote greater reliance on private investment. I would also like to think we will have a strong Export-Import Bank and foreign aid program to assist this process, but the Budget Committee is even now crafting a budget that would eliminate Eximbank loans and make deep cuts in U.S. aid.

On the other hand, where countries do not come to grips with their problems, no creditor plan will work and the regulators must ensure that U.S. banks recognize the possibility of losses.



April 1, 1987

STATEMENT OF SENATOR ALAN DIXON

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OVERSIGHT HEARINGS ON THIRD WORLD DEBT

MR. CHAIRMAN, I'M PLEASED ONCE AGAIN TO BE HERE THIS MORNING AS THE SUBCOMMITTEE CONTINUES ITS OVERSIGHT HEARINGS ON THIRD WORLD DEBT ISSUES. I WANT TO PARTICULARLY RECOGNIZE ~~WAYNE~~ ANDREAS OF ARCHER DANIELS FROM MY HOME STATE OF ILLINOIS. WE HAVE A DISTINGUISHED AND KNOWLEDGEABLE GROUP OF WITNESSES BEFORE US TODAY, AND I LOOK FORWARD TO HEARING THEIR TESTIMONY.

ONE YEAR AGO MUCH WAS SAID ABOUT THE GREAT SUCCESS OF THE ECONOMIC SUMMIT IN TOKYO. MANY OBSERVERS BELIEVED THAT THE UNITED STATES HAD ONCE AGAIN RESUMED ITS ROLE IN THESE NEGOTIATIONS AND TAKEN THE LEAD TOWARD A RESOLUTION OF THIS PROBLEM. HOWEVER, TODAY THIS COMMITTEE MEETS A YEAR LATER TO

FIND NO PROGRESS HAS BEEN MADE TO RELIEVE OR RESOLVE THE DEBT CRISIS. I HAVE GREAT RESPECT FOR SECRETARY OF THE TREASURY, JAMES BAKER. HOWEVER, AS I HAVE STATED BEFORE IN THIS COMMITTEE, I AM SKEPTICAL ABOUT SECRETARY BAKER'S DEBT RELIEF PLAN BECAUSE IT IS NOT A SOLUTION, BUT MERELY BUYS TIME.

IT IS A DELAY TECHNIQUE. I AM NOT AGAINST PROVIDING DEBT RELIEF TO LDC NATIONS. HOWEVER, WE MUST ADDRESS THE FUNDAMENTAL PROBLEMS UNDERLAYING THE LDC DEBT CRISIS. THE BAKER INITIATIVE IS A POSITIVE STEP, BUT MANY EXPERTS DO NOT AGREE THAT \$10 BILLION IN NEW CAPITAL WILL BE SUFFICIENT, NOR DOES IT PROVIDE LASTING RELIEF.

TODAY, BRAZIL FINDS ITSELF IN DANGER OF DEFAULT ON ITS DEBT. ONE YEAR AGO MEXICO WAS HAVING GREAT DIFFICULTY IN MANAGING ITS DEBT. THIS PROBLEM IS NOT CONFINED TO ONE OR TWO NATIONS, OR ANY LIMITED GROUP OF NATIONS, BUT EXTENDS TO NIGERIA, ARGENTINA, VENEZUELA, PERU, INDONESIA, EQUADOR, PHILIPPINES TO ONLY NAME A FEW.

U.S. BANKS ARE DANGEROUSLY OVEREXPOSED IN THIRD WORLD COUNTRIES. UNFORTUNATELY, I BELIEVE WITHOUT A LONG-TERM SOLUTION AND FUNDAMENTAL ECONOMIC REFORMS THE INTERNATIONAL DEBT CRISIS THREATENS TO BECOME A VICIOUS CYCLE, GROWING MORE AND MORE DIFFICULT FOR BOTH LDC'S AND OUR NATION'S BANKS TO ESCAPE.

I LOOK FORWARD TO HEARING THE VIEWS OF THIS MORNING'S WITNESSES ON THIRD WORLD DEBT AND ANY NEW LIGHT THAT CAN BE SHED ON THIS IMPORTANT SUBJECT.

Senator SARBANES. Mr. Coltman, why don't you go ahead and lead off.

STATEMENT OF CHARLES COLTMAN III, EXECUTIVE VICE PRESIDENT AND CHIEF LENDING OFFICER, PHILADELPHIA NATIONAL BANK

Mr. COLTMAN. Thank you, Mr. Chairman. I am Charles Coltman. I'm an executive vice president and chief lending officer of the Philadelphia National Bank.

The Philadelphia National Bank is the principal operating subsidiary of CoreStates Financial Corp. of Philadelphia. Our bank has been engaged in international banking for about 75 years, mostly in the trade finance area, and also providing trade services for foreign banks.

To put our overall international involvement in perspective, today our international assets are about \$1.6 billion, or 11 percent of our assets.

Our LDC exposure is now slightly below \$60 million, which comprises about 6 percent of our capital base. Three years ago, this figure was a good bit higher and comprised 27 percent of our capital. We have reduced this in an aggressive posture and have paid a price doing so.

I thank you, Mr. Chairman, for the invitation to speak here today on what is clearly a very complex problem. I would share Senator Proxmire's view that there are two fundamental views on the problem which are quite different; the first being the liquidity one—are we dealing with a short-term problem; will new lending for a period of time solve this—and I think that view is held certainly by some governmental agencies and certainly some large banks around the world.

The second view is that this is a solvency issue or at least partially a solvency issue. We're dealing with a basic inability of debtor countries to pay and that it will take years at best to solve the problem.

I do believe that many regionals and some European banks that I've talked to share this view.

Philadelphia National Bank has held the view that we are dealing to a large extent for a solvency issue over the past several years. We think that we are dealing with a very long term situation that will take perhaps as long as 50 years to totally resolve.

We believe that the LDC's will increasingly be unwilling to pay the social sacrifices to keep interest current and will not accept ongoing declining living standards year after year.

The Baker plan certainly recognized this and recognized the need for growth and also recognized that the issue was turning from an economic to a political issue.

If we continue, however, the way we are going, we do see a growing risk of a debtors' cartel developing and we think that losses of principal and interest will happen on some of this debt.

These views do contrast with the existing process that's now in place, a process involving restructuring every year or two, new money every few years which allows lenders to keep calling these loans performing and reporting income.

At the same time, the present process was extremely useful and valuable when it first began in 1982 and 1983. It certainly averted, in our opinion, a crisis that could have been much more serious.

At the same time, we now say that the banking systems around the world and individual banks have had time to adjust. There has been significant increased capital and internal growth and at the same time some individual write-downs.

Today we see the present process as perpetuating a fiction that loans are performing and that the interest is current. In our opinion, forced new money is nothing more than paying ourselves interest.

We would very much prefer to give cash flow relief to the debtor countries by rate reductions instead of an ongoing new money process, a process that seems to add debt on debt, interest on interest, and ultimately chokes off all possible recovery.

In some cases, we would also be prepared to take partial loss on principal instead of dealing with the 20 to 50 year problem.

We believe that there needs to be new thinking in this process and a less monolithic approach than has occurred before.

First, we would like some leeway be given to individual banks. Specifically, as I mentioned earlier, since the lowering of interest rates has the same general effect as new money on the borrower's cash flow, let those who wish to do so do so.

Another idea we would have would be to treat some of the old rescheduled debt as subordinated, with the servicing costs on that old debt clearly and specifically subordinated to new voluntary trade finance at market rates. We think that that will bring the LDC's back quicker to the voluntary lending market.

On a related point, we need to find new sources of finance for U.S. exporters to LDC's and I would certainly share the point that Senator Heinz made with respect to the Ex-Im Bank and the aid programs, but we need to do this in a way that doesn't bring about the risk that this new lending will be swept up in the old debt on an ongoing basis.

The Brazil freeze on trade finance did concern us, especially when at first there was no clear distinction between old debt and the new voluntary trade debt.

Finally, we believe that we need a stronger secondary market into which to sell some of our assets if banks so decide. Over the past 3 years, Philadelphia National Bank has sold over \$50 million of debt from eight different countries priced ranging from 62 cents to 81 cents and we've taken losses exceeding \$15 million. It would be very helpful to us and to the market if institutional mechanisms could be created to strengthen that market because in my own opinion the prices that one reads about are probably a good bit lower than they really should be.

There are certainly impediments to our thoughts here and one of the most difficult ones are the accounting effects of some of these approaches. Under the present rules, assets could well become non-performing, there might be loss of income, and possibly even some write-downs of values of the assets.

The impact of this would obviously be greater on some banks than others and naturally those with the highest exposure are likely to resist change and new ideas and new approaches. This we

certainly can understand, but why can't ways be found to let different banks take different approaches? Why can't the rules be relaxed temporarily to permit an adjustment period? We believe this has been done before and is being done in some industries today.

We would also note that existing regulatory and government views seem to discourage different approaches. The Federal Reserve has consistently supported the status quo and the present process and the Baker plan, while again identifying some very important points with respect to the need for these countries to grow, continues to use the forced new money approach.

Philadelphia National Bank believes that the LDC debt should start being handled the way we would handle most borrowers that become insolvent. Pending such an approach, however, our prudent view is to avoid new LDC exposures. Unfortunately, this will include financing international trade. Therefore, we will be looking at rate relief instead of new money, selling at a loss into the market at times, and certainly converting some of our debt into equity with the objective of managing the overall exposure down.

We recognize that this approach doesn't help finance our customers export to LDC's which we do want to do, and it doesn't add voluntary trade finance to the LDC's, but we see at this point no option to our general approach.

Thank you, Mr. Chairman. This concludes my remarks.

[The complete prepared statement of Charles L. Coltman III follows:]

Testimony
Charles L. Coltman III
Executive Vice President and Chief Lending Officer
Philadelphia National Bank
U.S. Senate Subcommittee on International Finance
April 1, 1987

Mr. Chairman and distinguished members of the subcommittee: I am Charles L. Coltman III, executive vice president and chief lending officer of Philadelphia National Bank. Philadelphia National Bank is the principal banking subsidiary of CoreStates Financial Corp, the largest commercial banking and financial services company based in Philadelphia. Philadelphia National Bank has been engaged actively in international banking throughout the 20th century, and for many decades has had a very substantial commitment to the kinds of international lending and funds movement services that are designed to expedite international trade and commerce. Most of my PNB career has been in international banking, and prior to my recent appointment as chief lending officer I headed the banking group within PNB which included our international banking and trade finance activities. These PNB activities represent most of

CoreStates' international banking activities. To place them in perspective, CoreStates' international assets at December 31 totaled \$1.62 billion, or approximately 11.1% of the corporation's \$14.6 billion total assets. Because of our primary orientation to financing trade, I might point out that our international assets include relatively small amounts of long-term or medium-term credits. In addition, our exposures in 13 problem countries that have been identified in recent years as vulnerable lesser developed countries is today less than \$60 million, or about 6% of our total equity capital. In early 1984, that figure stood at \$160 million or approximately 22% of equity capital. We have managed that figure down very deliberately, and over time have paid the cost of doing so, as I will discuss.

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I would like to thank you for the invitation to appear here today to give our views on some of the issues surrounding the complex problem of less-developed-country (LDC) debt. Opinions vary greatly on the problem, but most of them fall generally into two broad views which differ fundamentally from each other.

1. The first view is that the LDC debt difficulties are a problem of liquidity, of a cash shortage that is temporary and can be managed conventionally by short-term delay of payment terms, incremental lending and adjustments to the borrowers' economies. It also implies that this debt poses no serious threat to the international order. This is the view still held generally by U.S. money center banks, and it is at least implicitly the view underlying U.S. government approaches to the debt problem.

2. The second view is that the situation reflects more fundamental solvency problems -- basic inability to repay, even over a much longer term -- which for most if not all the LDCs will take many years to work out. This view is held by many regional banking companies, and many if not most European banks; and it is winning converts steadily as time passes.

Two years ago we were one of the first major banking companies to argue publicly the second view. At that time we allowed that quite

possibly, the problems of some of the LDCs would prove to be liquidity problems, and we mentioned Brazil as a possible example. Despite that country's current difficulties, we still believe in Brazil's capacity to weather its current illiquidity; today, however, we would also add Brazil to the list of countries that may be simply unable to repay all their debts over the medium to long term.

I mention the two views again today because I would like to draw out the logical implications of the second view. We see LDC solvency problems as implying a very long term situation -- maybe as long as 50 years. As successive years of this process pass, it is not surprising that LDCs are increasingly unwilling to commit themselves to the levels of internal social and political sacrifices needed to keep interest payments to foreign banks current, especially when such sacrifices imply a continuation of recent actual declines in living standards and no end appears in sight. The "Baker Plan" made a key point of the need for LDCs to reverse this decline and to have internal economic growth. In this it also recognized implicitly that the LDC debt issue was being shifted from the economic to the political sphere. We also see a growing risk of

creation of a "debtors cartel" among hard-pressed LDCs. From a lender's standpoint, we believe, as we have for some time, that losses of principal and interest are going to occur on the debt of these countries.

This clearly contrasts with the existing process applied to LDC debt, which is derived from the first view. This process emphasizes negotiated restructuring to tide the borrowers over their "temporary" problems and allows lenders to continue reporting income from the existing debt and its yearly increments. We consider this process to have been valuable and essential in 1982 and 1983, when we were addressing a problem that appeared to be new, at least in its dimensions, and the renegotiations averted crises or shocks that could have threatened the world financial system. Now we have had several years to see the problem more clearly than we could then, and individual banks and banking systems have had time to adjust to the threats that became apparent then by increasing their capital and writing down loans. Today the old, tired rescheduling process is perpetuating a fiction - the fiction that our LDC loans are performing and that the interest is

current. The "forced" new money that has become such a matter of contention each year among banks involved in the restructurings has amounted to nothing more than paying ourselves interest. FNB has long taken the position that we would prefer giving cash flow relief to deserving LDC borrowers by partial interest rate relief - by reducing interest rates below market - rather than lending "new money." New money only piles debt on debt and interest on interest until eventually it chokes off any real chance for recovery. For many of our own LDC debts, we also would prefer to take a partial loss on principal rather than to undertake a 20- to 50-year problem loan workout.

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Still following through the implications of what we consider to be solvency problems, let me suggest a few of the directions we would like to see in efforts going forward to resolve LDC debt issues. In our view the situation requires some new thinking and also requires a less monolithic overall approach. I would like to play out some principles without necessarily developing each one fully. I will follow by mentioning some of the objections being raised to these ideas, and our

responses to these objections. Obviously I will be happy to respond to your questions on any of these points.

1. We think it is past time to allow individual banks some

leeway in how they wish to deal with the problem. Why

should each participant in a renegotiated credit be required

to follow precisely the same formula as each other

participant in meeting its responsibilities to help resolve

the issue?

2. In this regard, I have already stated FBE's preference for

rate relief instead of new money. In a given restructuring,

typically a formula is negotiated modifying the terms of the

debt and establishing a percentage of "new money" to be

contributed by each participating lender. The borrower then

uses the new money to make interest payments. If a lender

wished to offer rate relief in lieu of new money, the rate

relief could be calculated so that it had exactly the same

net effect on the borrower's cash flow as if the correct

percentage of new money were being loaned. Obviously, it

would be beneficial to the borrower in the long run because it would reduce the incremental growth in the debt. At the same time it would have a neutral effect on the other lenders.

3. Another possibility that should be actively explored is to treat all or part of the rescheduled debt as though it were capital, or at least subordinated debt. The terms of this debt should be sufficiently long and its servicing costs should be clearly and specifically subordinated to servicing new, voluntary short-term trade finance at market terms. Such an approach will allow IDCs some added room for economic growth.

4. Related to that, we need to find ways in which we can finance our domestic customers, U.S. exporters, for short-term transactions without the risk of those credits being vacuumed into the long-term debts as part of the "old" debts' restructuring. Brazil's recent freeze of short-term trade debt was of particular concern to us, especially when

Senator SARBANES. Thank you very much, Mr. Coltman.
Mr. Guenther.

**STATEMENT OF JACK D. GUENTHER, SENIOR VICE PRESIDENT
AND SENIOR ADVISOR FOR INTERNATIONAL OPERATIONS, CITICORP/CITIBANK**

Mr. GUENTHER. Mr. Chairman, my name is Jack Guenther. I'm a senior vice president and senior advisor for international operations at Citicorp.

Thank you for inviting me to participate in this discussion. I have submitted a longer statement which, if you agree, I would request to have included in the record along with this oral statement.

As you know, Citicorp is deeply involved with many of the world's developing countries, not only in dollar lending but also in local currency business. We are, therefore, intimately concerned with their growth and welfare.

Advocates of a dramatic change in current strategy for dealing with developing area debt service problems advance four or five recurring themes. I and my colleagues at Citicorp believe that most of these ideas to be flawed or exaggerated or just plain wrong and we are concerned that if policies were to be based on these ideas they would have a chilling effect on private sector lending and increase the pressure for public funds.

I want to use my few minutes for an introductory statement to comment on some of these ideas. The first recurring theme is that the debt service problem is a prime contributing factor to the United States balance of payments difficulties and has cost the U.S. 1 million trade-related jobs.

Mr. Chairman, we clearly have a serious trade imbalance, but the root causes of that imbalance have very little to do with the debt problem. In 1980, the United States had a surplus of \$2 billion in the current account and balance of payments. By 1986, the balance had shifted to a deficit of almost \$150 billion. This deterioration was due to many factors, most importantly an overpriced dollar and the strong growth of U.S. public and private demand compared to that of our trading partners.

The deterioration in the U.S. trade accounts from 1980 to 1986 occurred with every major group of countries. The deficit with Japan rose by \$42 billion, with Western Europe by \$50 billion, with Canada by \$17 billion, with the newly industrializing countries of Asia by \$23 billion, and finally with Latin America by \$15 billion.

Much of the rhetoric has obviously overstated the debt service problems of developing countries as a contributor to this deterioration in the U.S. trade position.

In 1986, for example, our trade deficit with the whole of Latin America was less than the deficit with one country—Taiwan, a country with international reserves of almost \$50 billion and with no debt problem at all.

Clearly, the major reason for our global trade imbalance lies in our own hopefully temporary loss of competitiveness reflecting mainly the overpriced dollar, our large budget deficit, and the excessively restrictive practices of some of our allies in Europe and Asia.

The second recurring proposition states that growth in the debt-ridden countries has stopped because interest payments on past debts are too high and consume the funds needed for development.

The fact is that growth has not stopped everywhere and its pace is not simply a function of debt or debt service. Economic growth in many developing countries has been sporadic or not fully satisfactory since the Second World War.

The poorest growth has been in Africa. There are many reasons for this. One of the most important, as the World Bank has observed, is inadequate policies in agriculture and other sectors in the African countries themselves. But excessive debt to commercial banks certainly is not Africa's major problem. In fact, most African countries have the opposite difficulty. They have not enjoyed the credit-worthiness required for access to private capital markets on a substantial scale and must depend, therefore, almost exclusively on official capital.

Economic growth in the heavily indebted countries of Latin America, on the other hand, has been mixed. The reasons are complex and it is an oversimplification to suggest that growth in the mid-1980's revolves mainly around the debt question.

Certainly countries, such as Argentina, have had disappointing growth records for many decades. More recently, Argentina, a major grain producer, and Mexico, an energy supplier, have been hit by the same recessionary forces affecting grain and energy producing areas in the United States and worldwide, independently of the level of country debt. Even Saudi Arabia has not avoided a major recession and it has no debt at all.

GNP IN LATIN AMERICA

Despite these negative influences at work in Latin America from nondebt-related factors, a substantial recent recovery in economic activity has occurred. Real GNP in Latin America rose by 3 to 4 percent per year in both 1985 and 1986. This was about 1 percent higher than growth in the United States and Europe in each of these past 2 years, but, of course, below the growth rates of 6 percent per year enjoyed by these countries in the 1970's when they were utilizing large increments of foreign savings.

It is a gross distortion of fact to suggest that economic growth in the developing countries has ground to a halt and that the reason is simply the debt problem.

A third recurring theme, Mr. Chairman, is that commercial banks have stopped providing any net new capital to the heavily indebted countries. The debtors, it is sometimes added, actually are exporting capital to the creditor countries when the flow should be the other way around. The facts are otherwise.

The banks continue to lend net new funds and the debtors are not exporting capital. Let me explain.

Since 1982, commercial banks have arranged concerted new money packages totaling a little over \$40 billion for 16 different countries. As you know, a \$7 billion new money facility for Mexico is being finalized. Similar smaller packages are being arranged for Chile and Nigeria and one for Argentina is currently under negotiation.

On the other hand, only very small amortization payments are being made by these countries on their old outstanding debt of about \$300 billion because that debt has been rescheduled over 10 to 20 years with the initial grace period of several years. Therefore, a net inflow of capital of almost \$40 billion has gone to these countries over a 4- to 5 year period producing an average increase in their outstanding debt of about 2 percent a year.

Mr. Chairman, I would stress that this \$40 billion of new money was not an amount arrived at independently by the commercial banks. It was what the countries themselves requested and needed from the banks to support the economic and financial programs they had negotiated with the IMF and more recently the World Bank.

In the past 4 years, commercial banks have never failed to provide the amount requested to support these programs. Despite this steady increment of new bank loans at the level requested, a fourth proposition is frequently advanced; namely, that banks should be making a continuous net transfer of resources to the developing countries. In other words, the amount of new loans should exceed not only the amortization but also the interest payments on the old stock of debt. Since annual interest payments are equivalent to about 7 to 8 percent of outstanding debt, net new lending in this amount would mean that the outstanding debt would be increasing by at least 8 percent per year instead of the 2 percent now occurring.

Annual increases of 8 percent in the debt clearly would be excessive in many cases and would create debt service problems even where none existed. The countries know this. The IMF knows it. And the banks know it. This is why none of the programs submitted to the banks for financing by Mexico, Chile, Argentina, the Philippines, has ever called for such exaggerated flows of new loans on an annual basis.

Finally, I would call your attention to the fact that all the major borrowing countries in Asia are making net resource transfers to creditors in the sense that total interest payments exceed net new loans. Yet most of these countries continue to have high growth rates and rising international reserves.

Mr. Chairman, from what I've just said you will understand my concern that some critics of the debt problem management reveal a certain myopia about capital flows. They want the borrowers to have more loans but without more debt and are unable to see that in the real world the two are inseparable. The solution to this dilemma is to write down or default on or forgive old debt in order to be in a position to take on large quantities of new debt. Whether optional or mandated, these schemes send all the wrong signals into a system that is striving to re-assert itself and do what it has always done historically—mobilize surplus capital and move it to where capital is short under terms acceptable to all parties.

To sum up, I will offer an alternative set of propositions. They reflect Citicorp's view of the most promising approach to developing countries growth in the years ahead.

(1) We do not have a debt problem so much as a capital mobilization problem. The question is not old debt but how to provide the

future resources for sustained economic growth to the capital-short developing countries.

(2) Strong efforts must be made by the developing countries themselves to stimulate their own domestic savings, to retain those savings at home, and to attract back home the funds of their own citizens. Capital mobilization, in short, begins at home.

(3) Greater use must be made of equity capital which does not give rise to debt.

(4) Reasonable flows of new loans are a legitimate supplement to these other sources of capital. If properly employed, these funds will increase output sufficiently to service the loans fully and still leave residual benefits to the country. In fact, this is the ultimate test of whether loans should be made.

Unless the return on an investment is sufficient to service the loans and still leave the borrower better off, the loan should not be made in the first place.

(5) The idea that a politically driven write-down or forgiveness of debt will make private investors more likely to provide funds to that country in the future is completely misguided. The opposite is true. Debt forgiveness and interest rate relief schemes will postpone indefinitely the return to creditworthiness that debtor countries must seek if they are to attract private capital over the long run.

(6) Official lending is no more likely to provide the bulk of development loans in the next 20 years than it did in the past 20. Continued access to private capital markets is essential for the developing countries. The countries themselves are aware of this and that is why in almost every case they are making responsible efforts to work out satisfactory arrangements with lenders.

Thank you, Mr. Chairman.

[The complete prepared statement of Jack D. Guenther follows:]

at first there was no clear distinction between "old" debt and new, voluntary trade debt.

5. Finally, we need a stronger secondary market into which individual banks can sell their LDC loans at such times they may decide it is in their shareholders' interests to take their losses and move on to other activities. As we know from recent publicity in business publications, there is an active secondary market for loans sold at discount; according to information in the March 30 issue of Fortune, market prices for LDC loans recently ranged from 17 cents on the dollar for Peru to 74 cents for Philippines debt. Arguably, the true value of these loans could be higher if a deeper secondary market existed. Over the past few years, PNB has sold more than \$50 million of LDC loans from eight countries at prices ranging from 61 cents to 82 cents on the dollar, taking the losses on those sales. It would be helpful if institutional mechanisms could be created that would strengthen the secondary market and make it easier for

banks with views such as ours to choose loan sales as a means of reducing their exposures.

It would be foolhardy not to acknowledge the many impediments that exist to some of these suggestions, and that have greater impact on some lenders than on others.

The most obvious impediments lie in the accounting effects of some of these possible steps, particularly as they would affect U.S. lenders with large exposures. To simply capitalize interest payments (rather than going through the fiction of lending "new money" and taking it back as interest) would require that the affected loans be placed on non-performing status, a matter of great concern to banks these days, and would reduce reported income. A similar result occurs if a lender accepts below-market rate interest, although the impact on income is not quite as great. By writing down loan values to market a lender takes a reduction in income and capital. Debt-for-equity swaps reduce earning assets and earnings.

Because these effects weigh more heavily on banks with heavier exposures, those banks understandably tend to resist such measures.

Clearly there is value, however, in allowing different banks to take different approaches, and to reduce their vulnerability according to their own abilities, inclinations and timetables. We can also ask whether there is not a way to relax the accounting rules temporarily to ease the burden on banks that choose mechanisms other than new money for dealing with the problem. As I understand it the rules were relaxed for the insurance industry during the depression, and they are being bent today for the thrift industry. Put another way, if we must have fictions to preserve the stability of the most-exposed sectors of the banking industry, can't we be creative enough to devise a fiction that has less damaging long-term effects on the borrowers than the fiction we are using now?

I would also comment that the existing climate in regulatory and government quarters discourages new approaches. The weight of the Federal Reserve Board has consistently come down on the side of the status quo -- our existing process of renegotiation and restructuring. The Baker Plan, though containing some details that are new,

also perpetuates approaches based on the implicit perception that the problems are ones of liquidity, not solvency.

PNB is firmly committed to the view that LDC debt should now begin to be treated in the way we handle any debt when the borrowers become insolvent. Pending the development of a new approach by the industry, we believe the only prudent course for our shareholders requires us to avoid new LDC exposures, unfortunately even including trade finance; to avoid "new money" packages in lieu of rate relief or other measures we believe more beneficial in the long run; and to continue to sell LDC debt into the secondary market or to convert it into local equity, taking losses as required to manage the exposures downward in orderly fashion. We do not believe these acts of prudence are necessarily advantageous to the health of U.S. exports and trade, and we regret the potential effects on LDC economies of the lack of trade finance. But we do not see prudent alternatives given the existing policies being pursued by both governments and the lender committees for handling the problem.

Thank you.

Statement by

Jack D. Guenther

Senior Vice President and Senior Advisor for
International Operations,

Citicorp/Citibank

before the

Subcommittee on International Finance and Monetary Policy,
Committee on Banking, Housing and Urban Affairs,
United States Senate

April 1, 1987

Mr. Chairman:

Thank you for inviting me to participate in this discussion. As you know, Citicorp is deeply involved with many of the world's developing countries, not only in dollar lending but also in local currency business. We are, therefore, intimately concerned with their growth and welfare.

Advocates of a dramatic change in the current strategy for dealing with the developing area debt service problem advance four or five recurring themes. I and my colleagues at Citicorp believe most of these ideas to be flawed, or exaggerated, or just plain wrong. And we are concerned that if policies were to be based on these ideas, they would have a chilling effect on private sector lending and increase the pressure for public funds. I want to use my few minutes for an introductory statement to comment on some of these ideas.

The first recurring theme is that the debt service problem is a prime contributing factor to the United States balance of payments difficulties and has cost the U.S. one million trade-related jobs.

Mr. Chairman, we clearly have a serious trade imbalance, but the root causes of that imbalance have very little to do with the debt problem.

In 1980, the United States had a surplus of \$2 billion in the current account of the balance of payments; by 1986, the balance had shifted to a deficit of almost \$150 billion. This deterioration

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was due to many factors, most importantly an over-priced dollar and the strong growth of U.S. public and private demand compared to that of our trading partners.

The deterioration in the U.S. trade accounts from 1980 to 1986 occurred with every major group of countries. The deficit with Japan rose by \$42 billion, with Western Europe by \$50 billion, with Canada \$17 billion, with the newly industrializing countries of Asia by \$23 billion, and finally with Latin America by \$15 billion.

Much of the rhetoric has obviously overstated the debt service problems of developing countries as a contributor to this deterioration in the U.S. trade position. In 1986, for example, our trade deficit with the whole of Latin America was less than the deficit with one country, Taiwan, a country with international reserves of almost \$50 billion and no debt problem at all.

Clearly the major reason for our global trade imbalance lies in our own hopefully temporary loss of competitiveness, reflecting mainly the overpriced dollar, our large budget deficit, and the excessively restrictive practices of some of our allies in Europe and Asia.

The second recurring proposition states that growth in the debt-ridden countries has stopped because interest payments on past debts are too high and consume the funds needed for development.

The fact is that growth has not stopped everywhere, and its pace is not simply a function of debt or debt service.

Economic growth in many developing countries has been sporadic or not fully satisfactory since the Second World War. The poorest growth has been in Africa. There are many reasons for this. One of the most important, as the World Bank has observed, is inadequate policies in agriculture and other sectors in the African countries themselves. But excessive debt to commercial banks certainly is not Africa's major problem. In fact, most African countries have the opposite difficulty: they have not enjoyed the credit-worthiness required for access to private capital markets on a substantial scale and must depend, therefore, almost exclusively on official capital.

Economic growth in the heavily indebted countries of Latin America, on the other hand, has been mixed. The reasons are complex, and it is an oversimplification to suggest that growth in the mid-1980's revolves mainly around the debt question. Certain countries, such as Argentina, have had disappointing growth records for many

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decades. More recently, Argentina, a major grain producer and Mexico, an energy supplier have been hit by the same recessionary forces affecting grain and energy producing areas in the United States and worldwide, independently of the level of country debt. Even Saudi Arabia has not avoided a major recession, and it has no debt at all.

Despite these negative influences at work in Latin America, from non-debt related factors, a substantial recent recovery in economic activity has occurred. Real GNP in Latin America rose by 3% to 4% per year in both 1985 and 1986. This was about 1% higher than growth in the United States and Europe in each of the past two years, but, of course, below the growth rates of 6% per year enjoyed by these countries in the 1970's, when they were utilizing large increments of foreign savings. It is a gross distortion of the facts to suggest that economic growth in the developing countries has ground to a halt and that the reason is simply the debt problem.

A third recurring theme, Mr. Chairman, is that commercial banks have stopped providing any net new capital to the heavily indebted countries. The debtors, it is sometimes added, actually are exporting capital to the creditor countries, when the flow should be the other way around.

The facts are otherwise. The banks continue to lend new funds and the debtors are not exporting capital. Let me explain.

Since 1982, commercial banks have arranged concerted new money packages totaling a little over \$40 billion for 16 different countries. As you know, a \$7 billion new-money facility for Mexico is being finalized, similar small packages are being arranged for Chile and Nigeria, and one for Argentina is currently under negotiation. On the other hand, only very small amortization payments are being made by these countries on their old outstanding debt of about \$300 billion, because that debt has been rescheduled over 10 - 20 years with an initial grace period of several years. Therefore, a net inflow of capital of almost \$40 billion has gone to these countries over a 4 - 5 year period, producing an average increase in their outstanding debt of about 2% per year.

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Mr. Chairman, I should stress that this \$40 billion of new money was not an amount arrived at independently by the commercial banks. It was what the countries themselves requested and needed from the banks to support the economic and financial programs they had negotiated with the IMF and, more recently, the World Bank. In the past four years, commercial banks have never failed to provide the amount requested to support these programs.

Despite this steady increment of new bank loans at the level requested, a fourth proposition is frequently advanced, namely, that banks should be making a continuous "net transfer of resources" to the developing countries. In other words, the amount of new loans should exceed not only the amortization, but also the interest payments on the old stock of debt.

Since annual interest payments are equivalent to about 7 - 8% of outstanding debt, net new lending in this amount would mean that the outstanding debt would be increasing by at least 8% per year, instead of the 2% now occurring. Annual increases of 8% in the debt clearly would be excessive in many cases, and would create debt service problems even where none existed. The countries know this; the IMF knows it; and the banks know it. This is why none of the programs submitted to the banks for financing -- by Mexico, Chile, Argentina, the Philippines, Ecuador, Nigeria-- has ever called for such exaggerated flows of new loans on an annual basis. Finally, I would call your attention to the fact that all the major borrowing countries in Asia are making "net resource transfers" to creditors, in the sense that total interest payments exceed net new loans. Yet most of these countries continue to have high growth rates and rising international reserves.

Mr. Chairman, from what I have just said you will understand my concern that some critics of debt problem management reveal a certain myopia about capital flows -- they want the borrowers to have more loans but without more debt, and are unable to see that in the real world the two are inseparable. The solution to this dilemma is to "write down" or "default on" or "forgive" old debt, in order to be in a position to take on large quantities of new debt. Whether optional or mandated these schemes send all the wrong signals into a system that is striving to reassert itself and do what it has always done historically -- mobilize surplus capital and move it to where capital is short under terms acceptable to all parties.

To sum up, I will offer an alternative set of propositions. They reflect Citicorp's view of the most promising approach to developing country growth in the years ahead.

One: We do not have a debt problem so much as a capital mobilization problem. The question is not old debt but rather how to provide the future resources for sustained economic growth in the capital-short developing countries.

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Two: Strong efforts must be made by the developing countries themselves to stimulate their own domestic savings, to retain those savings at home, and to attract back home the funds of their own citizens. Capital mobilization, in short, begins at home.

Three: Greater use must be made of equity capital, which does not give rise to debt.

Four: Reasonable flows of new loans are a legitimate supplement to these other sources of capital. If properly employed, these funds will increase output sufficiently to service the loans fully and still leave residual benefits to the country. In fact, this is the ultimate test of whether the loans should be made. Unless the return on the investment is sufficient to service the loans and still leave the borrower better off, the loans should not be made in the first place.

Five: The idea that a politically driven "write-down" or "forgiveness" of debt will make private investors more likely to provide funds to that country in the future is completely misguided. The opposite is true. Debt forgiveness and interest rate relief schemes will postpone indefinitely the return to creditworthiness that debtor countries must seek if they are to attract private capital over the long term.

Six: Official lending is no more likely to provide the bulk of development loans in the next 20 years than it did in the past 20. Continued access to private capital markets is essential for the developing countries. The countries themselves are aware of this, and that is why, in almost every case, they are making responsible efforts to work out satisfactory arrangements with lenders.

The Role of External Private Capital Flows

John S. Reed

Chairman

CITICORP/CITIBANK

Background Paper Prepared for
IMF/World Bank Symposium on
Growth-Oriented Adjustment Programs
February 25, 26, and 27, 1987
Washington, D.C.

Revised March 12, 1987

This symposium on growth-oriented adjustment programs addresses the right issue at the right time, for the real challenge facing developing countries is how to reestablish long-term sustainable growth. This paper provides background information on the role that private capital from abroad can play in helping countries meet this challenge. In particular, it focuses on the role that commercial banks can play in the process.

During the ten years prior to 1982, commercial banks provided a significant portion of the total external capital supplied to developing countries. Since the debt problem emerged in 1982, banks have continued to provide normal financing to many developing countries, but they have limited their financing of countries with severe balance of payments problems to lending packages arranged in connection with rescheduling agreements.

The current system for managing the debt problem is based on unparalleled cooperation among private banks, debtor countries, creditor country governments, and the Bretton Woods Institutions. It is, however, widely agreed that this system is coming under increasing stress owing to the discrepancy between the

climate for investment created by certain countries and the conditions for investment required by the world capital markets.

This stress can be resolved in one of two ways:

1. Countries can succeed in improving the climate for investment and compete for capital on the terms established in the global capital markets. Over the long run -- and sustained growth requires a long-run view -- we believe this can result in a large, steady flow of funds to developing nations.

2. Alternatively, countries can seek to force providers of private capital to make special off-market concessions. This may give some short-term relief, but it will not attract funds in the global capital markets. This approach will force troubled countries to depend almost entirely on official flows of capital (which are in short supply) to supplement their own savings in financing economic development. Ultimately, official flows come from taxes paid by households and businesses in industrial countries. In this situation, debtor countries will be required to compete for resources in the political arenas of the industrial countries.

The choice between these approaches will be made largely by the developing countries themselves, since they make the policies that determine the path they will follow. The thrust of this paper is to show that it is in the best interests of all parties, particularly the capital-short countries, to take the measures necessary to maintain a creditworthy status in the global financial markets.

History

Starting in the early 1970s, just as the Bretton Woods system of fixed exchange rates was breaking apart, developing countries began to attract significant amounts of private foreign capital. Although the bulk of investment capital in developing countries continued to come from domestic savings, large external capital inflows added a significant boost to investment programs and permitted these countries to accelerate their economic growth in both aggregate and per capita terms.

Most of the external capital came from the world's private capital markets through loans syndicated by commercial banks in the major industrial countries. By the late 1970s, net external borrowing from these intermediaries accounted for over three fourths of the total net inflow of funds from abroad into capital

importing developing countries, while inflows from official creditors accounted for less than one third of the total.¹

Several factors accounted for this large increase in private external lending. The banks were willing to lend because developing countries appeared to be good risks in the 1970s. The prices for commodity exports were buoyant, and the outlook for continued growth in export earnings looked excellent. In effect, the developing countries appeared to have the capacity to carry larger amounts of external debt. From these countries' point of view, borrowing dollars was cheap with interest rates often less than inflation.

Another reason why developing countries turned to the private capital markets for funds during the 1970s was that the resources of the Bretton Woods Institutions were not keeping up with world trade and the financing needs of these countries. As late as 1970, the resources of the World Bank and the Fund were equivalent to over 15 percent of world imports and to

¹International Monetary Fund, World Economic Outlook (Washington: International Monetary Fund, October 1986), p. 87. These figures refer to the net external borrowing of capital importing developing countries from official and nonofficial sources, as derived from the borrowing country's current account balance. The data cover the period 1978-80. The total borrowing from official and nonofficial sources adds to more than 100 percent since countries built up reserves during these years.

over 70 percent of the external debt of the developing countries (Figure 1). During the course of the 1970s, however, these two percentages fell to approximately 6 percent of world imports and to less than 30 percent of external debt. As a result, when the world economic environment started to change in 1979 because of the second oil price shock and the anti-inflation policies adopted in the United States and other leading industrial countries, the financing requirements of the developing countries had grown out of proportion to the resources of the Bretton Woods Institutions. Consequently, the resolution of the debt problem required a great deal of cooperation among the Bretton Woods Institutions, the private lenders, and the developing countries.

As is well known, the debt problem emerged in August 1982, when Mexico declared itself unable to service its debt in a timely fashion. Since then some 61 countries have had trouble servicing their external debt, while 63 have not.² A comparison of countries in these two categories gives many clues as to why this is the case. By and large countries that had difficulty servicing their debt went into the debt crisis with higher ratios of debt to income and higher barriers to

²International Monetary Fund, World Economic Outlook, October 1986, p. 34.

trade and investment.³ Also they had higher rates of money growth and inflation, which in turn frequently led to overvalued currencies and depressed export receipts (see Table 1).⁴ In combination, these policies meant that countries with debt-servicing problems went into the debt crisis with much higher ratios of external debt and debt service to exports -- a situation that left the countries more vulnerable to a world recession.

When that recession came in 1979-82, these countries in many cases compounded their difficulties by clinging to the inward focus of their old policies. They tried to postpone adjustments by borrowing more. They further increased their rates of money growth and inflation. In many cases (e.g., Argentina, Chile, Mexico, Venezuela), they allowed their currencies to become enormously overvalued, which had disastrous effects on their current accounts. Coupled with the

³ Much of this can be traced to import substitution policies that were started decades earlier. These policies led to protected markets which stymied domestic competition and encouraged the rise of large, inefficient, government-dominated industrial sectors that could not compete on world markets.

⁴ In other relevant categories, however, the two sets of countries were not significantly different. Their rates of real economic growth were about the same; the prices of their non-oil commodity exports grew at about the same rate; and the gross rate of capital formation was only slightly lower in the countries with debt-servicing problems (see Table 1).

rise in short-term dollar interest rates, the lack of adjustment caused the ratio of interest payments to exports to jump 2 1/2 times to 24.3 percent between 1978 and 1982.⁵ At the same time, foreign exchange reserves plummeted from 25 percent to 10 percent of imports (see Table 1). This decline in reserves relative to financing requirements was the final blow that closed countries' access to the voluntary capital markets and brought about the debt crisis of 1982.

Since then, there have been two phases in resolving the debt problem. The first, which began in 1982, involved reestablishing cash flow equilibrium, or balance in the current account, through short-term adjustment programs under the aegis of the Fund. The second phase may be said to have started in October 1985, when Secretary Baker launched a new growth-oriented adjustment concept designed to help countries get back on the path to long-term sustainable growth.

The first phase of resolving the debt problem occurred in relatively favorable economic

⁵In contrast, countries that did not subsequently have debt-servicing problems went into the global recession in a stronger position and reacted quickly to the changed international environment. They allowed their ratio of debt to income to rise only modestly, so that their interest burden remained relatively manageable. (see Table 1).

circumstances. Industrial countries, led by the United States, recovered rapidly from the severe 1980-82 recession, and this helped reverse the decline in exports that the troubled debtors had experienced in 1981-82. Interest rates declined significantly from their peak in 1981, although they remained relatively high in real terms. Initially at least, commodity prices rebounded (before falling again in 1985).

Within this favorable economic environment, troubled countries and their creditors began to work out a resolution to the debt problem. The approach was country by country, since the problems and the solutions were also largely dependant on the economic policies that each country chose to adopt. By and large, countries that rescheduled their debts took policy measures needed to improve their balance of payments. Often these policy changes were a precondition for the country to receive a Fund loan and to receive new money or restructured maturities from private lenders and governments. The policy changes usually included a devaluation of the currency, a reduction in money growth, a decline in the government budget deficit, and the elimination of wage and price controls. Each country negotiated the timing and content of its particular program with the Fund and then negotiated rescheduling and new money agreements with the banks.

These policies were effective in reducing the aggregate current account deficit of the problem countries from \$63.1 billion in 1982 to \$3.1 billion in 1985 and in bringing about a slight reduction in the average ratio of interest to exports of goods and services, from 24.1 percent in 1982 to 23.0 percent in 1985 (see Table 1). Essentially, the adjustment programs stabilized the debt situation.

This inevitable adjustment in the balance of payments was not always carried out smoothly and at minimum cost. In many cases payments arrears developed, essential imports were not available, and the nature of the cutbacks in expenditures was influenced by the political constraints in each country. Unfortunately, from the standpoint of long-term growth, there was a marked decline in the rate of gross capital formation in the troubled debtor nations from 24.9 percent (1979-82) to 18.5 percent (1983-85). Real economic activity stagnated or declined. Total gross domestic product (GDP) rose by only 3 percent from 1983 to 1985, and real GDP per capita actually fell by 4 percent.

Although the external accounts of most developing countries were brought into reasonable balance by 1984, the problem remained how to renew a process of sustained economic growth.

This need is at the heart of the Baker Initiative. As originally presented, the Baker Initiative is a three-pronged program involving the debtor countries, the Bretton Woods Institutions (and other multilateral development banks), and the private commercial banks. The scheme is simple: if debtor countries adopt growth-oriented, market-driven economic policies, both the multilateral institutions and the commercial banks are to provide the largest troubled debtor nations with a sustained injection of external capital.⁶

According to Secretary Baker's speech in Seoul announcing the Initiative, the growth-oriented, market-related policies that countries should adopt in order to qualify for new money include:

- o maintenance of market exchange rates,
interest rates, wages and prices
- o the adoption of sound monetary and
fiscal policies

⁶Countries included in the Baker Initiative are: Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. Together, these countries account for over 80 percent of the debt of the 61 countries with recent debt-servicing problems.

o the implementation of growth-oriented structural reforms.

To obtain new money, countries are to correct the economic policies that caused the debt problem in the first place. In return for adopting these growth-oriented, market-driven policies, countries are to receive additional loans from official and private sources. Specifically, both the Fund and the World Bank are to provide additional credit, provided these countries adopt the necessary structural policy changes. Indeed, Fund and World Bank loans are to contain conditionality clauses to that effect, and the World Bank is to shift its emphasis from project finance to adjustment lending to help assure that countries do adopt the needed reforms. Finally, commercial banks are to supply \$20 billion in new financing to the largest troubled debtor nations, again provided that the countries adopt the necessary structural reforms. The Baker Initiative is clear: new money to support new policies.

Like many new initiatives, the Baker Initiative has been slow getting off the ground. Despite these delays, in some countries it is bringing about important changes in attitudes and policies. As the title of this symposium implies, the emphasis is now increasingly on growth, and that is all to the good.

In fact, many countries (including Chile, Cote d'Ivoire, Ecuador, Morocco, Nigeria, and Turkey) are now moving toward implementing the initial reforms required to produce sustained growth. In most cases, the reforms fall short of the ideal, but the willingness of countries to change deeply ingrained policies is certainly a step in the right direction.

The Current Situation

Logically, then, the current situation should represent a transition from the stabilization programs begun in 1982 to the growth phase announced with the Baker Initiative in October, 1985. In practice, however, a debate has arisen concerning whether countries should proceed along these lines at all or whether instead they should seek to "resolve" the debt problem through some form of debt relief. This latter approach calls for concessions from the banks and could lead to a breakdown of the bank restructuring committee process. This is an important turning point in the resolution of the debt problem and the long-term growth prospects for the countries.

Before turning to the debate, it is useful to review the debt situation as it now stands. Total external debt of the developing countries amounts to \$967 billion (see Table 2). More than half of this

amount (\$573 billion) is owed by countries that are experiencing problems in servicing their external debt in a timely fashion. These countries owe approximately \$400 billion to private creditors, principally commercial banks from the industrial countries.

Debt owed by countries with debt servicing problems is concentrated in fifteen large, heavily indebted nations, and it is precisely on these nations that the Baker Initiative focuses. These fifteen nations account for over two thirds of the total debt owed by all countries with debt-servicing problems and for over four fifths of the debt owed by such countries to private creditors (see Table 2).

By any modern standard, the debt burden is high for these problem countries. At yearend 1986, their interest payment requirements averaged 23 percent of export revenues, and for the largest troubled debtors, the figure was 28 percent, or approximately four times the level of interest service due from countries without debt-servicing problems (see Table 3). It should be noted, however, that countries with debt-servicing problems have rebuilt their foreign reserves from the extraordinarily low levels reached in 1982, and in some cases (e.g., Venezuela) reserves amount to a significant percentage of the outstanding debt.

Also, it should be noted that countries without debt servicing problems continue to enjoy normal access to the world capital markets. In other words, for countries that continue to meet the standards of the market, lenders are willing and able to supply new money (see Table 3). We feel this also can be the case for countries with debt-servicing problems if they take the measures necessary to make themselves creditworthy again.

Indeed, many banks are now in a much stronger financial position to extend new credit to troubled countries than they were when the debt problem started in 1982. Through building up their reserves and capital, U.S. banks' exposure to troubled debtor nations now accounts for a much smaller portion of capital and earnings than it did in 1982. Also, the debt problem has largely been discounted in the price of U. S. bank stocks. In the case of the German, Japanese, and Swiss banks, the decline of the dollar relative to their currencies has effectively reduced the portion of problem country exposure in their balance sheets by 30 percent or more. Furthermore, it is widely believed that many of these banks have reserves that fully cover this exposure.

Ironically, the financial cost suffered by the banking system increases the strength of the banks and is putting a great strain on the bank restructuring

process. Banks are now more able to lend new money, but they are also more able to "walk away" from the process entirely. Demands for concessional terms by debtor countries will drive many banks away from the restructuring and new money agreements. There is a great concern that more pressure for concessions will cause a breakdown of the bank restructuring process, especially if creditor governments should join in advocating such concessions.

Typically, a committee of 10 to 14 banks represents the hundreds of banks around the world that are creditors to a country, and separate committees exist to conduct negotiations with each problem country. Members of the committee come from many different nations. They are chosen by the debtor government on the basis of their exposure and geographical representation and are to represent the views of the banks of their country or region in the negotiations. Although banks on a committee are usually the largest bank lenders to the country in question, the committee members in aggregate generally represent only 25 percent to 35 percent of a country's total external debt to commercial banks. Thus, the committee itself cannot finalize a deal; it must "sell" it to hundreds of banks, small and large, in many countries.

For this reason, much of a committee's function involves communicating with all other participants in the rescheduling process. In effect, a committee serves as a go-between for the debtor country and the hundreds of banks that have extended it credit, and a committee must seek to negotiate terms and conditions that are acceptable to the debtor country and that will encourage other banks to participate in the new financing. In addition, a committee is responsible for coordinating the efforts of the commercial banks with those of the Bretton Woods Institutions and with those of the creditor country governments.⁷

The ability to sell a particular deal to banks around the world depends on the economic policies the country is following and on the terms and conditions of

⁷ Much of this work is done by subcommittees that focus on particular aspects of a deal. For example, the economic subcommittees evaluate the economic data supplied by the debtor government to the banks, brief the banks on developments in the country's economy and on changes proposed for the country's economic policies, and work closely with economists from the Bretton Woods Institutions, the debtor country government, and the creditor country governments to provide input into policy decisions by the debtor country government. Depending on the individual country and negotiation, there are also subcommittees that focus on trade financing, cofinancing (with the World Bank), interbank lines, and other matters. These subcommittees have worked to maintain critical short-term financing and to develop a wider menu of financing options. As are the committees themselves, the subcommittees of each committee are comprised of many different banks from a number of different countries.

the deal itself. Structural adjustments along the lines proposed under the Baker Initiative and appropriate macroeconomic policies are essential, since they establish the fundamental conditions that determine the outlook for economic growth and the ability to service debt; however, structural adjustments and good policies are not sufficient in themselves to attract new money. They must be accompanied by market-related pricing and terms in order to be sold to banks around the world. After all, the commercial banks are intermediaries between the world's capital markets and the debtors. Since banks fund themselves at market rates, anything less than market rates represents a loss for them, and they are reluctant to go along.

The difficulty experienced in placing the recent Mexican debt restructuring is a clear example of this. Even more important than the low spread, the package includes concessions in the form of contingency financing and does not offer a menu of options, including on-lending to the private sector. Certain banks around the world have been reluctant to participate in the package and placing it is exhausting goodwill in some areas of the banking community. We now see countries with relatively good economic performance and policies having difficulty in their negotiations because they are demanding non-market-

features that in their novelty raise substantive and accounting issues. Citibank has been vocal about this because we feel further demands for concessions and unusual arrangements will damage the bank support system and curtail the early momentum of the Baker Initiative.

Turning Point

Currently there appears to be general acceptance of the principles espoused in the Baker Initiative, that is, that the problem is how to get the troubled debtor nations back on the road to long-term sustainable growth, and that the solution invariably entails adopting growth-oriented, market-related economic policies. But what should those policies be, how fast should they be adopted, and should they be accompanied by market terms and conditions on the new funds that troubled debtor nations seek to obtain from abroad? Those are the open questions, and how they are resolved will determine the amount of external financing that developing nations can expect to receive from commercial banks and other private sources of capital during the coming years.

Two schools of thought prevail on how to resolve these open questions. One school argues that lending should be on concessional terms and that countries

should be given a longer period of time in which to phase in the new market-oriented economic policies. Some would go so far as to say that the concessions should take the form of debt relief or debt forgiveness.

The other school of thought says that if countries want to return to the market, they should adapt to the conditions of the market. If they meet these conditions, they will restore their creditworthiness and attract new private capital for economic growth. If they do not, investors, be they commercial banks or other sources of private capital, will direct their capital into other uses, and the problem countries will not be able to obtain the external capital they need for economic growth.

Each school of thought bases its recommendation, to some extent, on a calculation of the funds that troubled debtor countries can expect to receive. Those who argue for concessional terms focus on the short-term, on the easing of the debt burden that troubled debtor nations can expect to achieve during the next two to three years. Those who argue for market-related terms focus on the funds that countries can expect to receive over the longer term and on the contribution that such funds can make to help or achieve long-term sustainable growth.

The concessional school of thought implicitly assumes that the major source of funds to the troubled debtor nations are those funds that can be "extracted" in the form of concessions from existing lenders. Proposals for concessions range from not-so-freely negotiated reductions in the spreads on new or existing money to mandatory forgiveness of interest and principal. Virtually all proposals envision that the problem countries must adopt market-oriented structural reforms along the lines of those outlined in the Baker Initiative in order to qualify for debt relief. But even the most far-reaching of these proposals offers relatively little in the way of additional resources to the countries concerned. For the 15 heavily indebted countries, the debt relief envisioned under these proposals amounts to less than 4 percent of the country's exports of goods and services and less than 1 percent of the country's GDP, and for no country would the proposed relief exceed 6 percent of the country's exports of goods and services. It is therefore hard to see that debt relief, by itself, will put countries back on the path to long-term sustainable growth.

If countries are, in any event, to take the market-oriented policy measures envisioned under the Baker Initiative (and under the proposals for debt relief), countries will also find it in their long-term interest to agree to market-related terms and

conditions on any new money that they receive from the world capital market. This will assure that these countries have sustained access to the world capital markets, just as the developing countries without debt-servicing difficulties continue to have (see Table 3).

Pricing is only one part of what is meant by market terms and conditions. In fact, this concept represents a broad menu of possible programs. Some are designed to improve the balance sheet of the troubled debtor nation by bringing more equity investment into the country, either from foreigners or domestic residents repatriating capital held abroad. Others are designed to channel credit to the private sector and to support structural reform efforts. The mechanisms by which these programs are implemented can be as varied as the programs themselves. Debt-equity swaps, the creation of mutual funds, and on-lending to private enterprises can be valuable tools in promoting a market-related environment.

As countries adopt market-driven strategies, there will be clear improvements in the investment climate. More investors, both domestic and foreign, will be attracted by investment opportunities, and greater investment flows will be channeled into the economy. This will ease the country's debt burden by reducing its dependence on debt finance today and by improving

its income-producing potential in the years to come. Both of these developments would make it possible, in our opinion, to conclude debt reschedulings and new money packages at lower spreads.

Some examples of the gains from market-driven programs are striking. Canada, for example, has traditionally relied on external capital to supplement its domestic savings. In fact, Canada has about the same reliance on external capital relative to GDP as Argentina, Brazil and Mexico. However, Canada's policies have created an environment more conducive to investment and capital inflow throughout most of its modern history. As a result, Canada has funded its external balance sheet primarily through equity and securities, while Argentina, Brazil and Mexico have relied heavily on bank debt.

If countries opt for the concessional school of thought, and the associated confrontational attitudes, it is safe to say that they can expect little or no new capital from private sources, especially commercial banks. The little they may attract from private sources would be very expensive. Private investors have a full range of investment opportunities; they have no reason to put their funds where they cannot expect to receive a market rate of return and where repayment is in serious question. That is particularly true for commercial banks, which are only

intermediaries between borrowers and depositors from whom the banks themselves borrow money.

Furthermore, if countries opt for the concessional school, it is likely that they will have to depend, at least for a number of years, to a significant degree on official sources of foreign capital to supplement whatever internal savings their economies may generate. How large are such flows likely to be? It is worth noting that during the last four years the large-troubled debtors almost doubled their share of net new official credit, which represented around 70 percent of the increase in net new official credit supplied to developing countries (see Table 5). Even so, this much larger share of official capital has been meager. During the height of the debt problem (1982-86), large troubled debtor nations received official credits amounting on average to 1.6 percent of their GDP. Earlier (1978-81), these countries had received annual credit inflows amounting to 6 percent of their GDP. Even today countries without debt-servicing difficulties receive total annual credit inflows amounting on average to 2.3 percent of their GDP, or three fourths again as much as the large troubled debtor nations have been receiving from official sources (see Table 5). Clearly, returning to the world capital markets holds out prospects for greater inflows

Senator SARBANES. Thank you, sir.
Ms. Shelton-Colby.

STATEMENT OF SALLY SHELTON-COLBY, BANKING CONSULTANT

Ms. SHELTON-COLBY. Thank you, Mr. Chairman.

Since I gather that our remarks have been submitted for the record, I will try to summarize very briefly.

My concern about the Latin American debt issue is that we are seeing not only a continuing economic problem in Latin America but also a social and political problem emerging as well. In fact, I think it is quite extraordinary that now facing the 6th year of the Latin American debt crisis we have seen Latin America respond in relatively muted way.

LATIN AMERICAN DEBT CRISIS

I would suggest that there are four reasons why we have not yet seen serious social or political ramifications to the worst crisis to have hit Latin America since the Great Depression; I would suggest that each of these four reasons which I'm about to offer are basically at an end.

First, the middle class has been living off savings which accrued during the boom years of the 1960s and the 1970's and those savings are virtually on the edge of depletion.

Second, the extended family network has so far been surprisingly resilient, but when you're facing year after year of economic stagnation, if not recession, then not even the extended family network can continue to cushion the effect forever of double digit unemployment.

Third, the need for economic adjustment in order to resume growth has been generally acknowledged in Latin America by an educated, aware populace; the burden of adjustment will be supported politically to the extent that Latin America believes it will bring about a return to international credit-worthiness and economic growth.

So far, neither has happened, in spite of the fact that we are now, as I say, facing the 6th year of the debt crisis.

Last, the democratization process in Latin America has raised hopes that democratically elected governments would be more adept at economic management than authoritarian regimes. We have already seen one government in Latin America fall primarily as a result of the economic adjustment process; that government was the Government of Panama. I fear that, unless there is a return of economic growth to Latin America, a move which would have to be preceded by some form of debt relief, we are inevitably over the course of the next few years going to see debt-induced economic recession begin to take its toll on fledgling democratic political systems in this area.

As one debates the Latin American debt crisis and whether there is a crisis or not, one normally does not talk about the social costs. We have almost no reliable data on the social impact of debt, but it is clear that there are serious problems. Malnutrition has increased substantially. Diseases which were thought to have disappeared decades ago have reappeared. The average Latin American today

of resources from abroad and for faster economic growth.

Furthermore, there is no guarantee that the large troubled debtor nations will be able to continue to secure such a large share of the official credit given to developing countries, or that official credit will continue to expand at the same rate it has in the past. There is considerable political competition for the resources of official organizations. For example, there are many contenders for the official credit currently available, and a strong case has been made that a greater share of official credit and aid should be given to the truly needy African countries rather than to the relatively well-to-do problem debtor nations.

There is also considerable internal political competition for funds that provide the source of official credit -- that is, taxes in industrial countries. In most industrial countries the capital contributions for the entities that grant official credit must be appropriated by the legislature. That puts the Fund, the World Bank, and other multilateral development banks into direct competition with domestic constituencies for health care, unemployment benefits, military expenditures, farm aid, and industrial programs, particularly programs for declining industries that might be harmed by greater exports from the

countries to which official credit often is granted. And, as Figure 1 demonstrates, that battle has proven to be a losing one for the proponents of more official credit to developing countries.

Thus, staking one's economic future on the ability to attract official inflows of capital seems a hazardous proposition. If countries are to take the market-oriented policy measures needed to qualify for debt concessions under the proposals made to date, then it would seem in their long term self-interest to incorporate market-related terms and conditions into their debt reschedulings and new money packages. That is the way back to the world capital market, and that is the way toward long-term sustainable growth.

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Conclusion

We are at an important turning point in the resolution of the debt problem with developing countries. We must choose whether we are going to permit the financial disciplines transmitted by the banking system to run their course and restore corrective action or whether these disciplines are to be temporarily avoided by support for concessional lending and slow progress on fundamental economic reforms.

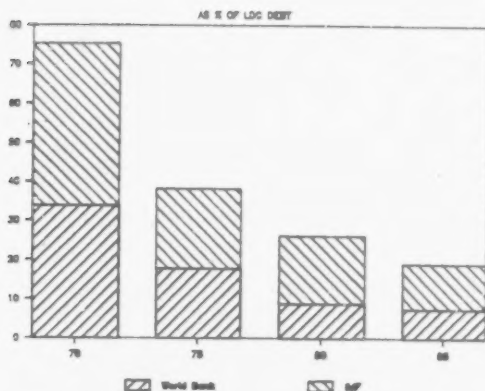
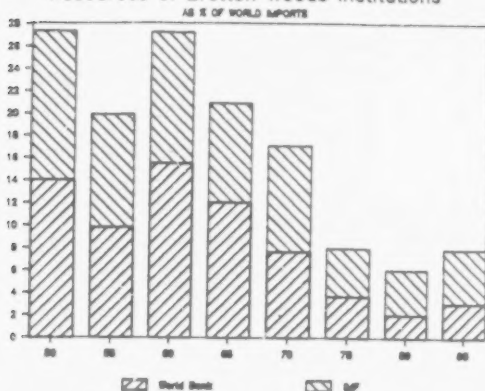
In our view, banks are intermediaries between savers and debtors. Banks borrow from savers and relend to debtors. Savers provide funds to banks, but on terms and conditions that are beyond the control of banks. The reality is that savers will not provide significant amounts of funds to banks, unless borrowers from banks also meet market terms and conditions. Consequently, it is the role of the banking system to bring pressure to bear on any borrower -- be it a domestic manufacturer or a troubled debtor nation -- when the borrower takes steps that will jeopardize its ability to service its debt in a timely fashion. This pressure usually takes the form of refusing to lend, unless and until the borrower takes the steps necessary to restore its creditworthiness. Thus, the pressures transmitted by the banking system should be viewed as part of the recovery process that will induce countries to take the steps necessary to get back on the path to long-term sustainable growth. In this sense, the role banks play by not lending when conditions are wrong is as important as the role that banks play by lending when conditions are right.

We believe the principles set forth in the Baker Initiative are sound. We also believe that banks and other private sources will provide capital to troubled debtor nations as long as countries adopt market-oriented policies and as long as countries adapt

to the conditions imposed by the world financial markets. Banks stand ready, willing and able to help debtor countries cultivate access to these markets, but banks cannot change the fundamental conditions demanded by these markets, for banks themselves are ultimately subject to the discipline of these same markets. Debtor countries must recognize this, if they wish to enlist bank support in restoring and sustaining the high rates of economic growth they need and deserve.

Figure 1

Resources of Bretton Woods Institutions



Source: IMF, International Financial Statistics, various issues; OECD, Financing and External Debt of Developing Countries, 1986; World Bank, Annual Report, various issues.

Table 1
MAJOR ECONOMIC INDICATORS
(all data in percent)

	Countries with Debt-servicing Problems	Countries without Debt-servicing Problems
Real Growth:		
Total GDP		
1968-78	5.4	6.0
1979-82	2.8	4.5
1983-85	1.0	6.1
Per capita		
1968-78	3.1	3.7
1979-82	0.5	4.5
1983-85	-1.3	4.1
Gross Capital Formation		
1978	27.2	29.0
1979-82	24.9	27.8
1983-85	18.5	26.1
Terms of Trade		
1968-78	1.9	0.7
1979-82	1.6	0.4
1983-85	-0.5	-6.4
Non-Oil Commodity Prices		
1968-78	8.4	8.7
1979-82	-0.4	0.1
1983-85	-0.6	-0.5
Debt/GDP		
1978	31.4	19.9
1982	43.2	24.1
1985	48.6	31.7
Interest/Exports of Goods and Services		
1978	9.6	4.6
1982	24.3	7.2
1985	23.0	7.7
Reserves/Imports		
1978	25.2	26.3
1982	10.1	22.0
1985	20.0	26.4

Table 1 (con't.)
MAJOR ECONOMIC INDICATORS
(all data in percent)

	Countries with Debt-servicing Problems	Countries without Debt-servicing Problems
Growth in Export Volume		
1968-78	3.7	8.3
1979-82	0.4	5.1
1983-85	4.4	8.9
Exports of Goods and Services/GDP		
1978	17.5	21.2
1982	18.1	26.6
1985	18.4	29.3
Money Growth		
1978	38.8	20.7
1979-82	47.3	27.7
1983-85	87.8	23.7
Inflation		
1968-78	21.6	9.8
1979-82	41.3	14.6
1983-85	83.8	21.4

Source: IMF, World Economic Outlook, October 1986.

Table 2

DEVELOPING COUNTRY DEBT PROFILE
year-end 1986
(all figures in \$ billions)

	Countries with Debt-servicing Problems	Countries without Debt-servicing Problems	Total
Total Debt	572.8	394.5	967.3
Due to Official Creditors	169.5	165.9	335.4
Due to Private Creditors	403.3	228.6	631.9
of which: Fifteen Heavily Indebted ** Countries			
Total Debt	431.1		
Due to Official Creditors	80.6		
Due to Private Creditors	350.5		

* Includes all short-term debt.

** Includes Colombia, which has not had debt servicing problems.

Source: IMF, World Economic Outlook, October 1986.

Table 3
DEVELOPING COUNTRY DEBT PROFILE
year-end 1986
(all figures in percent)

	Fifteen Heavily Indebted Countries	Countries With Debt-servicing Problems	Countries Without Debt-servicing Problems
Debt/GDP	46.6	49.1	32.2
Interest/ Exports of Goods and Services	28.1	23.1	7.3
Reserves/Imports	26.8	19.8	26.2
Annual Rate of Growth in ** Real Debt:			
Total Debt			
1978-82	9.9	8.7	4.1
1982-86	0.0	0.6	6.7
Debt Due to Private Creditors			
1978-82	11.5	9.5	6.1
1982-86	-2.0	-2.1	6.9

* Includes Colombia, which has not had debt-servicing problems.

** Nominal debt deflated by U.S. GNP Deflator.

Source: IMF, World Economic Outlook, October 1986.

Table 4

Members of Bank Advisory Committees

(9 Share of Committee in Total Bank Exposure)

<u>Argentina</u>	<u>Brazil</u>	<u>Chile</u>
Bank of America Bank of Tokyo Chase Manhattan Citibank Credit Lyonnais Credit Suisse Dresdner Bank Lloyds Bank Manufacturers Hanover Morgan Guaranty Royal Bank of Canada (24%)	Arab Banking Corp. Bank of America Bank of Montreal Bank of Tokyo Bankers Trust Chase Manhattan Chemical Bank Citibank Credit Lyonnais Deutsche Bank Lloyds Bank Manufacturers Hanover Morgan Guaranty UBS (30%)	Bank of America Bank of Nova Scotia Bank of Tokyo Bankers Trust Chase Manhattan Chemical Bank Citibank Credit Suisse Dresdner Bank Manufacturers Hanover* Marine Midland Morgan Guaranty (35%)
<u>Mexico</u>	<u>Philippines</u>	<u>Venezuela</u>
Bank of America* Bank of Montreal Bank of Tokyo Bankers Trust Chase Manhattan Chemical Bank Citibank Deutsche Bank Lloyds Bank Manufacturers Hanover Morgan Guaranty Societe Generale Swiss Bank (26%)	Bank of America Bank of Montreal Bank of Tokyo Banque Nationale de Paris Barclays Citibank Chase Manhattan Chemical Bank Dresdner Bank The Fuji Bank Manufacturers Hanover* Morgan Guaranty (36%)	Banca Nazionale del Lavoro Bank of America* Bank of Tokyo Chase Manhattan* Chemical Bank Citibank Commerzbank* Lloyds Bank Manufacturers Hanover Morgan Guaranty Banque Paribas Royal Bank of Canada Swiss Bank (27%)

*Chairman, Deputy Chairman, or Co-Chairman

Table 5

ANALYSIS OF OFFICIAL CREDIT
TO DEVELOPING COUNTRIES
1978-86

	Fifteen Heavily Indebted Countries	All Countries With Debt-servicing Problems	Countries Without Debt-servicing Problems
Net New Official Credit (\$ billion)			
1978-82	15.8	48.0	41.2
1982-86	34.3	63.7	51.7
Share of Net New Official Credit (%)			
1978-82	17.7	53.8	46.2
1982-86	31.5	55.2	44.8
Official Credit as % of GDP			
1978-81	0.7	1.4	1.2
1982-86	1.6	2.1	1.0
All Credit as % of GDP			
1978-81	6.0	5.7	2.8
1982-86	2.3	2.5	2.3

* Includes Colombia which has not had debt-servicing problems.

Source: IMF, World Economic Outlook, October 1986.

consumes fewer calories than he did in 1975. Infant mortality rates have risen sharply.

So I think one can come to no conclusion other than that the long-term social impact of debt will be a severely less healthy, less educated, and less nourished Latin America than that of today.

Now I think it is important to keep in mind that the major debtors in Latin America have made very important, and I would say frequently painful, efforts to adjust their economies. There is no question that budget deficits have been reduced. Mexico has cut its in half. Inefficient state-owned enterprises have been privatized or shut down. Tariffs and quotas protecting inefficient local industry have begun to be dismantled. Currencies have been devalued in order to maintain internationally competitive exchange rates. Exports have been substantially expanded and imports have been cut.

In fact, in some countries we are even seeing flight capital begin to return and this is especially the case in Mexico. But nevertheless, Mr. Chairman, Latin America's economy is still very much in trouble.

The 1986 per capita income is below the level of 1980. Non-oil commodity prices have fallen to their lowest level in 50 years and I don't know of any commodity specialist who predicts that they are going to go back up, with perhaps one or two exceptions.

The gross domestic product in 1986 slipped by almost a full percentage point from the already low 1985 level. The oil-exporting countries saw their 1984 \$8.6 billion current account surplus replaced by a \$7.5 billion deficit in 1986.

In most countries of the region, debt indicators grew worse and, Mr. Chairman, I have some data which I would ask to be included in the record.

Senator SARBANES. It will be so included.

[The following information was subsequently submitted for the record:]

Debt Relative to Exports and GDP and Debt Service Ratios
(in percent)

<u>Reporting Area</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
	<u>Debt to Exports</u>		1/		
Capital-Importing Developing Countries	151	161	154	169	180
of which					
Africa	148	165	165	182	212
Asia	87	92	86	99	106
Western Hemisphere	273	290	275	296	331
15 Major Debtors*	269	290	270	285	325
Argentina	448	471	484	479	559
Brazil	354	376	337	359	357
Mexico	320	328	299	328	422
Venezuela	180	183	178	202	288
	<u>Debt to GDP</u>				
Capital-Importing Developing Countries	34	36	37	40	40
of which					
Africa	36	39	39	45	44
Asia	22	23	23	28	30
Western Hemisphere	44	49	47	46	47
15 Major Debtors*	42	48	46	46	47
Argentina	82	71	61	75	70
Brazil	31	47	52	48	42
Mexico	57	70	58	60	69
Venezuela	55	49	74	68	61
	<u>Debt Service Ratios</u>		1/		
Capital-Importing Developing Countries	25	22	23	24	26
of which					
Africa	21	23	26	28	34
Asia	11	11	12	13	13
Western Hemisphere	51	42	41	40	46
15 Major Debtors*	49	42	41	40	47
Argentina	103	123	99	90	98
Brazil	88	74	64	76	92
Mexico	55	54	50	53	54
Venezuela	na	na	na	29	46

Source: IMF, World Economic Outlook, October 1986.

1/ Ratio to exports of goods and services.

* Treasury Dept. estimates. Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Ms. SHELTON-COLBY. It was prepared by the Department of the Treasury, apparently drawn from their own sources as well as from the IMF, and almost all of these indicators—these are debt-to-GDP ratios, debt-to-export ratios and debt service ratios—are worse in 1986 than they were in 1982.

DEBT-TO-EXPORT RATIOS

In addition, according to the World Bank, debt-to-export ratios rose 17 percent last year to a new historic high. Debt-to-export ratios were 60 percent higher than at the beginning of the debt crisis.

Let me put it another way. Last year, according to the World Bank, interest payments amounted to 5.3 percent of GDP while the trade surplus amounted to 2.3 percent of GDP. Now to the Latin American in the street, these macroeconomic indicators have more tangible meaning. They mean high unemployment, high rates of bankruptcies, high prices, and higher cost education and health care. I would also point out—and Mr. Guenther and I may have different figures; mine are drawn from the World Bank—Latin America, for each of the last 5 years, has sent abroad on a net basis approximately \$25 billion per annum in net capital remittances. That is over and above new lending and new investment.

Politically, Mr. Chairman, and economically, these trends simply cannot continue. The political mainstream in Latin America welcomes the Baker plan's emphasis on growth, but it was and remains dubious about the potential success of a strategy that would increase the absolute size of the debt without concomitant concessions to ease the debt service burden.

I spend about one-third of every month in Latin America and I am consistently struck by the growing demands for resumption of economic growth and for debt relief. These demands are no longer coming from the extreme left, but rather they are coming from the political center and even from the private sector in Latin America, from Latin American bankers, from businessmen—both American businessmen and Latin American businessmen—who see their businesses suffering as a result of what they perceive to be debt-induced recession.

I very strongly agree with Mr. Guenther that the debt overhang is not the only reason for the recession that Latin America has suffered during the last 5 years, but it is one of the reasons. And I think we should not be complacent about the figures for 1986. Mr. Guenther pointed to overall growth figures in 1986. The figures that I've shared with you, which as I say come primarily from the World Bank, the IMF, and some from our very own Treasury Department, would seem to indicate otherwise.

Let me just take 2 minutes on this point, Mr. Chairman. Yes, Brazil achieved a rate of growth of about 8.5 to 9 percent last year—no question about it. But that growth rate is "artificial" because it was achieved as a result of a consumer-led miniboom which resulted in an overheating of the economy and Brazil's returning to triple digit inflation. Moreover, the figure distorts the growth figures for the rest of the continent.

This year, most economists are projecting that Brazil will suffer between 1 and 2 percent negative growth.

Argentina achieved about 4 to 4.5 percent growth last year. Most economists I know are projecting more stagnant growth this year.

Peru achieved 8.5 percent growth last year, in good part because it did not pay a penny to the banks or to most of the multilateral development institutions.

The only two countries, in my view, in Latin America out of the entire continent that achieved healthy, real sustainable growth were Chile and Colombia. I fear that the 1987 figures for the continent as a whole are going to be far less healthy than the 1986 figures were.

So to conclude, Mr. Chairman, we are facing a very serious problem. Latin America is not recovering on a sustained basis. 1983 was a very bad year. 1984 was a little better. 1985 was bad. 1986 was a little better. 1987 is probably not going to be so good, particularly if interest rates begin to go back up.

So, in my view, some form of debt relief is needed, not only to get growth to resume in Latin America, but also, unless the creditor countries and credit institutions take the initiative, the debtors are going to take the initiative. And I believe some form of debt relief that is done in a context of sufficient flexibility for the banks is essential not only to get growth going in Latin America but also for the U.S. economy as well.

Thank you.

[The complete prepared statement of Sally Shelton-Colby follows:]

PREPARED STATEMENT OF SALLY SHELTON-COLBY

Mr. Chairman, I applaud the Subcommittee for holding these hearings on proposals to provide relief to those affected by the international debt problem. For some time the debate on how well Latin debtors especially were managing the external debt crisis has veered between extremes. Some have pronounced the debt crisis behind us and some debtors as being on the verge of returning to creditworthiness. Others have predicted widespread failure to recover economically and growing political demands for new approaches. A large number of new proposals have surfaced for dealing with the debt, many involving debt forgiveness.

I would like to share with you and the Subcommittee, Mr. Chairman, my evaluation of the economic situation in Latin America and then discuss a new, much more complex element, the politics. The record should reflect that a very great deal is at stake here. The U.S. has vitally important political and strategic interests in Latin America and the Caribbean which could be jeopardized by prolonged economic stagnation in the region. A democratic, economically healthy Latin America is vital to U.S. interests and to cooperative efforts in the areas of drug eradication, migration, trade, and security. It is also an essential ingredient in our ability to project our military capability on a global basis. Lacking the need to maintain substantial force levels to secure our southern border, we are free to deploy those forces in areas of immediate potential conflict, such as the Middle East and the Korean Peninsula. In addition, our ability to meet our NATO commitments in the event of an outbreak of hostilities in that area would be directly dependent on unimpeded access to sea lanes of communication passing through the Caribbean Basin and the northern part of South America. And the Panama Canal remains important, though less so than in the past, to U.S. commercial and strategic interests.

Economically, the almost 400 million people of Latin America are an obvious important market for U.S. exports. Latin America takes one-fifth of our exports, or used to before the debt crisis took its toll on our sales to that market. With one out of every six American jobs directly related to exports, it is clear that economic deterioration in Latin America not only affects our exports, which fell by \$15 billion between 1981 and 1983 alone, but also affects employment in this country. Over 400,000 jobs -- and some have put it at twice that -- have been lost in the U.S. as a result of the downturn in Latin America's economy; the impact in some areas, such as my home state of Texas, has been devastating.

The effect of economic decline and induced austerity on the social and political system of Latin America is growing serious. It is remarkable that Latin America has remained as stable as it has during the worst economic crisis it has faced since the Great Depression. I would like to suggest four explanations for Latin America's relatively muted response -- to date-- to the debt crisis. First, the middle class has been living off savings accrued during the boom years of the sixties and seventies. Second, the extended family network has so far been surprisingly resilient. Third, the need for economic adjustment in order to resume growth has been acknowledged by an educated, aware populace willing to share in the burden of adjustment for a time. Fourth, the democratization process has raised hopes that democratically-elected governments would be more adept at economic management than authoritarian regimes.

Mr. Chairman, these four elements cannot and will not continue to cushion the impact of debt indefinitely. Middle income sector savings are close to depletion. Lower income sectors are now bearing the burden of social ills which many thought were gone forever. Economic retrenchment has not yet brought about sufficiently robust economic growth as a reward for years of austerity. Democratic regimes have to be more responsive than authoritarian governments to increasingly frustrated Latin American voters whose incomes have fallen to roughly the level of a decade ago.

Permit me to comment briefly on one aspect of the debt crisis which has received far too little attention: the social cost. There is a tendency among those of us who work on Latin America to focus on the stunning modernization process that has obviously occurred in Latin America over the last 25 years. It is true

that Latin America is now more urban than rural; that manufactured products, including arms, compete with if not outpace exports of coffee and other basic commodities; that Latin America's GNP has grown to 20% of the U.S.; that production in Latin America during most of the past 25 years has grown at a faster rate than in the U.S.; and that major investments in social infrastructure put Latin America on a par with middle-income Western European countries.

But these data mask a social situation in Latin America seriously exacerbated by the debt crisis. It is estimated that 40% of the population of that area was living in poverty during the 1970s and there is no evidence of any significant change for the better. On the contrary. Reliable data on social decline are not yet available, but some general observations can be made. There is little question that malnutrition has increased substantially. Diseases which were thought to have disappeared decades ago have reappeared. The average Latin today consumes fewer calories daily than in 1975 when it was estimated that only one-third of the population ate a subsistence diet. Infant mortality rates have risen sharply. Population pressures resulted in over ten million people entering the work force between 1981-1983 alone. In addition, it appears that the distribution of income, traditionally unevenly distributed in Latin America, has worsened considerably...all this in an area with virtually no social security safety net and double-digit unemployment. I would also call the Subcommittee's attention to the long-term impact of the cuts in social programs which Latin America is being forced to make. Can one come to any conclusion other than that the long-term social impact of debt will be a severely less healthy, less educated, less nourished Latin America than that of today?

Most Latin governments have made serious, and politically painful, efforts to adjust their economies. Budget deficits have been reduced (Mexico has cut its in half), inefficient state-owned enterprises have been privatized or closed, tariffs and quotas protecting local industries have begun to be dismantled, currencies have been devalued to maintain competitive exchange rates, exports have been substantially expanded and imports cut. In fact some flight capital has even returned.

However, Mr. Chairman, Latin America's economy is still in trouble. 1986 per capita income remained below the 1980 level. Non-oil commodity prices fell to their lowest level in fifty years. Gross domestic product slipped by almost a full

percentage point from the already low 1985 level. Population growth spurred ahead of economic growth. The oil-exporting countries saw their 1984 \$8.6 billion current account surplus replaced by a \$7.5 billion deficit in 1986 and their trade surpluses financed only one-fourth of their interest payments instead of all of them as previously (source: Economic Commission on Latin America). Argentina and Brazil, in spite of a decline in the price of oil and interest rates, ended 1986 with current account deficits. Inflation re-surfaced as a serious problem in some countries. Only Chile and Colombia were able to continue the adjustment process and achieve reasonably healthy level of growth. In most countries of the region debt indicators grew worse as the U.S. Department of the Treasury has acknowledged. According to World Bank data, debt to export ratios rose 17% to a new historic high for the region generally. In fact, debt to export ratios were 60% higher than before the onset of the debt crisis. Interest payments to export ratios were 20% higher, in spite of the fact that LIBOR fell by well over 50% in these years. Put another way, interest payments amounted to 5.3% of GDP in 1986 while the trade surplus amounted to 2.3% of GDP; obviously the latin countries paid teh banks more than they earned, leaving nothing for growth. Where growth has occurred it has been short-lived and fragile, with few exceptions.

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To the Latin-in-the-street, these economic indicators mean recession: high unemployment, high rate of bankruptcies, high prices, and higher-cost education and health care for a populace whose per capita income has plunged. At the same time, Latin America sent abroad about \$25 billion per annum in net capital remittances during the past five years while new lending and investment have virtually dried up. Even Brazil, for the first time in several years, experienced no meaningful new investment.

The toll on the U.S. economy through lost exports has been serious as well. A September 1986 report prepared by the Democratic Staff of the Joint Economic Committee indicates that developing countries accounted for 87% of the \$23 billion recorded decline in U.S. exports through 1985. Exports to Latin America fell by \$12 billion, or about 55% of the total decline. While the strong U.S. dollar might explain this situation in part, this same report points out that U.S. exports to industrial countries fell by less than 2%, or roughly \$3 billion. The fall-off in U.S. exports to the highly indebted Latin countries can be explained by the fact that Latin governments restrained demand through the reduction of governmental expenditures and real wages. In addition, currencies were devalued so that exchange

rates promoted exports and discouraged imports. In spite of a sharp increase in the volume of goods exported, severely deteriorated terms of trade meant that the unit value of exports fell 20% for non-oil exporters and 45% for oil exporters, thereby virtually eliminating the effects of the increased exports.

Mr. Chairman, Latin Americans have begun to question the efficacy of a strategy that has achieved neither a return to financial creditworthiness nor a resumption of economic growth. There are limits to any country's ability to endure social and economic decline and Latin America is no exception, especially after almost a quarter century of (sometimes spectacular) economic growth. Those limits are evidenced by the appearance of a broad new set of demands from the Latin populace for debt relief and economic growth. These demands are emanating no longer just from the extreme left but also now from mainstream centrist democratic political elements and even from the local private sector. Throughout Latin America, governments have begun to reject the idea of continued austerity merely in order to service the debt and instead are moving increasingly towards the growth option, even if that has to occur at the expense of the foreign banks. While the political mainstream in Latin America welcomed the Baker Plan's emphasis on growth, it is dubious about the potential success of a strategy that would increase the absolute size of the debt without concomitant concessions to ease the debt service burden. In Brazil, for example, President Sarney's policy of prioritizing growth over debt servicing is broadly supported by the majority of Brazil's political leaders. If a choice between growth and servicing the external debt were to become necessary, no major political element in Brazil today would favor servicing the external debt at the expense of domestic economic growth. Underpinning this development is the recognition that Brazil's newly democratic government will have to face that country's enormous social problems whose solution will require the expenditure of substantial public funds. A recent report prepared at the request of the Government of Brazil concludes that though Brazil's economic progress has been dramatic, its social indicators put it among the hemisphere's least developed countries. While Brazil has long suffered staggering social underdevelopment, it will not be so easy to ignore under a democratic administration. Therefore, the new Brazilian government will have to make some hard choices between servicing its external debt and achieving growth levels high enough to allow it to address in a serious way the social demands building up under twenty-five years of military government.

The Mexican Government as well has opted for a pro-growth strategy which required the international financial community to come up with a new approach to that country's debt, one that involves less austerity and more growth. Pressures from within the Mexican political establishment itself -- not to mention from opposition parties, the private sector, agriculture and trade unions -- are escalating. Many components of the ruling PRI power structure have called for debt relief as an essential ingredient in reversing the economic decline Mexico has experienced for most of the past five years. These pressures produced 1986's unprecedented Mexico-IMF agreement, negotiated with the backing of the U.S. Government, and the subsequent agreement with the commercial banks. Both legitimate more growth and less austerity in the form of substantially increased capital flows and higher than ever before budget deficits. It was based in part on a presumption by U.S. Government and IMF officials that social and political pressures in Mexico were explosive and an early resumption of growth was therefore indispensable.

In Argentina, the Alfonsín administration as well is coming under intense pressure from all major elements of the Argentine body politic, including his own Radical Party, to get growth going again. This pattern is replicated across the continent as Latins begin to express their unwillingness to tolerate additional recession or stagnation as the price of servicing the external debt. Peru's refusal to service the external debt and its achieving 8.5% growth this year cannot but have made an impression on the rest of the continent.

Unless growth resumes soon, the international financial community may see not only a prolongation of Brazil's suspension of interest payments but over the longer-term other countries following suit. This could seriously jeopardize the banks and create new strains in the U.S. banking system. The general vulnerability of the banking system to external shocks is significantly less than at the onset of the debt crisis in 1982. U.S. money center bank exposure to the nine most highly indebted countries has fallen from 170% of primary capital in 1982 to 110% by the end of 1985. This is due primarily to an increase in primary capital of 56% between 1982 and 1985. This has produced a fall in exposure relative to capital to the most highly indebted countries from 170% in 1982 to 110% in 1985. In addition, reserve levels have now been built up and reserve accumulation will presumably continue to grow.

If the banks were to face an indefinite suspension of debt

service by a major debtor or debtors and were to retaliate by suspending short-term credits or seizing foreign assets, serious new frictions would arise in the already tense relationship between the U.S. Government and its important Latin allies. This could carry over and damage important U.S. interests in other areas such as cooperation on drug enforcement, migration, trade, and of course Central America. Moreover, it could provide fertile ground to the blandishments of Soviet General Secretary Mikhail Gorbachev during his first visit to Latin America later this year.

To return to the Baker Plan, creditor and debtor countries and financial institutions generally reacted favorably to the idea, especially to the notion of stressing the need for resumption of growth; however, there was considerably less enthusiasm, at least among the banks, for actually increasing lending. While the banks have signed on rhetorically, they have yet to commit significant new funds to the area and net lending has actually declined dramatically. In 1985 net capital inflows into Latin America were only \$2 billion and in 1986 \$9 billion.

Commercial bank attitudes towards new lending to Latin America, Baker Plan or no Baker Plan, can largely be explained by the shock that the banks experienced in 1982 and subsequently from the failure of Latin America to have recovered creditworthiness within the time frame anticipated. They continue to be reluctant to take on substantial new risk, especially without some kind of guarantee from either official or multilateral bodies.

Mr. Chairman, may I venture my own, personal views on where and how we go from here. There is no question that a new approach to managing the debt, acceptable to both creditors and debtors, is necessary. Latin America and other debtors can no longer afford, economically or politically, to spend such a large percentage of export earnings and government revenue to service the external debt. Some form of debt relief, that is, a reduction in the debt service burden, is required in order to get growth going again and to achieve a return to creditworthiness on the part of the debtors. At the same time debt relief has to be implemented in such a way as to safeguard the stability of the international financial system. At this point I am inclined to think that, before moving towards dramatic new solutions such as major debt write-downs or the creation of new facilities to purchase discounted bank paper, we should try a simpler approach. I believe that LDC debt should be stretched out over a much longer time frame, perhaps forty years or more, to reduce servicing

requirements significantly. Interest rates charged by the banks should be brought way down; if interest rates go back up, then the World Bank and/or the IMF should create a new facility to cushion the impact on LDCs. Banks should agree to a slower pace of adjustment in order to preserve their hopes of repayment which would be jeopardized by the disruptive social and political side effects of the present trends. Like it or not, commercial banks must set up "country growth funds" to ensure the debtors a reasonable level of growth; terms could depend on the condition of each borrower. Bank overseers must adjust their regulatory requirements so as to give the banks more time and flexibility to adjust to reduced income and increased exposure. Debt forgiveness should only be needed for the poorest countries.

The debtors must renew their commitment to economic adjustment which, along with international monitoring of that process by the IMF, should be a condition of the more relaxed repayment terms. Those countries which find the IMF politically unacceptable could agree to a new monitoring process: periodic reviews of domestic economic performance by the more sympathetically-viewed World Bank (which could include IMF personnel on its teams). This would be the basis for determining future disbursements into the debtors' growth funds by the banks. Debtors should also vigorously promote debt-to-equity conversions as an effective albeit modest way of reducing the stock of debt. Sustained commitment to economic adjustment and the resumption of growth are also the best means for inducing not only the return of flight capital but also new foreign capital.

The U.S. Government and others, besides relaxing the banks' regulatory environment, should not insist that official credits be repaid before commercial credits, should link bridge financing for LDCs to compliance with adjustment programs, and should consider such new tools as government and World Bank guarantees of commercial bank financing in order to stimulate new capital lending.

Mr. Chairman, a reduction in the debt service burden and continued efforts at adjustment should result in economic growth, the only sure way of defusing this increasingly explosive conundrum, and of as much value to the American economy as the Latin.

Senator SARBANES. Thank you very much. We appreciate the testimony from the panel.

Mr. Guenther, I want to make sure I understand the points you made. On page 2, you say, for example, in 1986 our trade deficit with the whole of Latin America was less than the deficit with one country—Taiwan.

Mr. GUENTHER. Yes.

Senator SARBANES. Leaving the Taiwan problem to one side for the moment, and I think that's a serious problem in terms of that bilateral trade deficit and the currency management which they have obviously engaged in—they run a large trade surplus and continue to move their currency in the opposite direction, which is an interesting phenomenon. But is your point on Latin America simply that the deficit figure is less? Your point isn't the extent of the shift from a surplus figure to a deficit figure, is it?

Mr. GUENTHER. Well, either way you measure it. In the previous paragraph I refer to the shift. The previous paragraph mentions the shift from 1980 to 1986 was \$15 billion in Latin America and I give what the shift was with respect to other people.

Senator SARBANES. All right. But when you then shift to Taiwan, you're not using the same—you shifted from apples to oranges I take it at that point.

Mr. GUENTHER. Yes, that's right. There are two ways that you can worry about it—either what the shift was from 1980 to 1986 or what the absolute deficit was in 1986. And I shift to apples and oranges in the sense that it is sometimes looked at either way and I think that either way is a legitimate way of looking at it. Whether you look at the shift or you look at the absolute level of the deficit, Latin America represents about 10 percent of the problem, whether you look at it on the shift basis or on the absolute level.

My point was only that, yes, we have lost with respect to Latin America on a shift and we have the deficit, but it's not out of line with what's happened in the rest of the world and, therefore, I would interpret this much more as a loss of competitiveness on the part of the United States than any particular problem pertaining to Latin America.

DEBT PROBLEM AND ECONOMIC GROWTH

Senator SARBANES. You don't deny that the debt problem is part of the reason that the economic growth in these developing countries has been negatively affected, do you?

Mr. GUENTHER. Well, I would not deny that it's a part, but I would certainly say it is a very, very small part. Clearly, one of the problems, as Ms. Shelton-Colby said, is the types of things they export are very, very low in price right now. These countries are exporting grain. These countries are exporting petroleum. The President of Uruguay said last year he didn't so much have a debt problem as he had a trade problem—a low price for his commodities. These are all serious problems.

The economic policies of some of the countries have hurt. So I would not deny that debt is a part of it, but I would say it is a small part and a greatly exaggerated part.

Korea has a great deal of debt, Mr. Chairman. Korea, per capita or in relation to national income, has a debt almost as big as anyone in Latin America, and the Korean growth rates are the fastest in the world.

Senator SARBANES. Well, now the austerity program that the Latin American countries pursued until the Baker plan sought to change the approach I think are generally perceived as having a major impact on American producers. First of all, we lost export markets in Latin America and, second of all, we had much more intense competition from Latin American producers seeking export into this country.

In fact—you know, we tend to use different tables. I have some World Bank figures that the value of U.S. exports to six of the heavily indebted Latin American countries dropped from \$32 billion to \$22 billion from 1981 to 1986, and meanwhile the imports from those countries into the U.S. rose from \$28 to \$38 billion. So you went from a \$4 billion U.S. merchandise trade surplus with those countries to a \$20 billion trade deficit.

Mr. GUENTHER. Could I comment on that?

Senator SARBANES. I think there's a general perception, at least now with Latin America on those figures, that the debt had a great deal to do with it and that the measures adopted by those countries in order to meet the debt obligations were very directly and intimately tied to these deteriorating trade figures because they had to restrain themselves not to take American exports and they had to seek to maximize their own exports in order to have earnings to service the debt. So you have almost here about a \$25 billion deterioration in the trade deficit.

Now do you differ in any significant way with that analysis?

Mr. GUENTHER. Well, yes, in this sense, Mr. Chairman. I'm glad that you asked it and I'm glad you have all those figures in front of you so we can talk the details.

You chose 1981 to 1986. I don't know if you have the individual country breakdowns there. Do you have Mexico? Mexico's imports in 1978 were \$8 billion and Mexico's imports rose from 1978 to 1981 to \$24 billion. They tripled in 3 years.

Senator SARBANES. Imports from whom?

Mr. GUENTHER. Their total imports. Mexico's total imports in 1978 were \$8 billion. In 1981, they were \$24 billion. Do you have something like that on the table?

Senator SARBANES. I just have the United States-Mexico figures.

Mr. GUENTHER. Well, let me give you the total in order to see why my interpretation would be different. Mexico's total imports went from \$8 billion in 1978 to \$24 billion in 1981. They have now fallen back down and they've averaged about \$12 billion the last 2 or 3 years.

The \$24 billion that Mexico imported in 1981 was completely unsustainable. There was no way that they could sustain import levels like that. This was at the peak of the euphoria when they thought oil prices were going to \$50 a barrel. This wasn't even imports related to \$30 a barrel oil. This was on people's expectation that it was going on up. That was a completely unsustainable level of imports and to measure the U.S. exports to that country from a 1981 base is to completely miss the fact that it was impossible to

sustain it at that level, whether they had any debt or not. Their current earnings from oil were simply nowhere near the amount necessary to sustain that type of imports.

Senator SARBANES. Did you want to address that?

Ms. SHELTON-COLBY. Frankly, Senator, I agree with Mr. Guenther on this point. If you'll remember, 1978 to 1981 in Mexico was during a period of wild, irresponsible, uncontrolled spending during the oil boom years by the previous Mexican administration and that level of imports really cannot be sustained.

But I agree with what I think is your view, Senator, that there is no question in my mind that U.S. exports to Latin America, including Mexico, have fallen off rather dramatically, generally because of the need to devalue currencies.

Let me just take Mexico as a case in point. Mexico has devalued its currency on a number of occasions since the debt crisis hit in 1981. Right now Mexico's currency is undervalued. It may be as much as 20 or 25 percent undervalued. So not only are they pumping more into the U.S. economy in order to service their debt, but they are also buying less from us.

The other point I would just like to emphasize goes back to the trade element here. I think that the trade side of the debt issue in Latin America really needs to be emphasized more than it has because, as we have been suggesting, most Latin American countries have not diversified their export structure away from dependence on a few basic commodities. Commodity prices are very, very, very depressed.

Even Brazil, which everyone always holds up as the example of a successful economic diversification program, still depends for almost half of its foreign exchange earnings on commodity prices. Argentina's industrial structure is totally antiquated and uncompetitive. So we basically have countries, to sum up, that are still dependent on commodity prices and they urgently need to push forward the diversification and industrialization process in their country.

All that being said, there is no question in my mind, just look at the figures, that the bulk of foreign exchange earnings are going to service the debt. There's just nothing left over for growth.

Mr. GUENTHER. Mr. Chairman, could I make one comment on that?

Senator SARBANES. Surely.

Mr. GUENTHER. It is true—certainly I would agree that Mexico has devalued its currency quite a bit precisely to encourage nonpetroleum exports, but I wouldn't say they are doing that to try to pay the debt. They are trying to do that to create jobs which Mexico badly needs to do, the same way we do. And they have the same pressures that we do to create jobs in Mexico and that's what they are attempting to do by expanding their exports.

Senator SARBANES. Let me just put two questions and then I'll yield to Senator Gramm, and I will come back on another round.

Mr. Guenther, I want to make sure I understand. At the bottom of page 5, is it your assertion that the amount in these various packages that are put together to address the debt problem that is to come from the commercial banks is sort of independently arrived at without the commercial banks being involved and then

they sort of say to the commercial banks, "Well, this is how much money we need from you," and the commercial banks have never failed to provide the amounts requested to support these programs? I didn't really quite understand it worked that way. Is that the way you perceive it as working?

Mr. GUENTHER. Yes, that is basically the way it works. We have never put money into a country unless it had a viable medium-term financial program negotiated with the IMF. Now the last year or so——

Senator SARBANES. When they negotiate that program, do they take into account what they think they can get out of the banks or do they negotiate it independently and then the banks ante up for whatever they arrive at?

Mr. GUENTHER. I was an employee at the IMF for 19 years, Mr. Chairman, heading the missions to Brazil and Argentina and so forth. The way the IMF would negotiate a program with one of these countries is to look at their needs for development but also to be very conscious of the fact that foreign borrowing cannot go up too rapidly because these countries already do have a heavy debt and one cannot borrow money abroad in unlimited quantities. And therefore, the IMF and the Mexicans negotiated and decided that \$7 billion was a reasonable amount for the Mexicans to borrow over this 1 or 2 year period, taking into consideration their needs, the problem that they suffered from a sharp drop in petroleum prices, but also taking into consideration the fact that you have to keep the growth of debt under control.

After they have negotiated that number, then they go to the commercial banks and seek to have this program financed and banks have never——

Senator SARBANES. Don't they make some judgment about what the banks are prepared to put in in the course of putting together the program?

Mr. GUENTHER. Well, I would say they might, but I would say they are looking mainly——

Senator SARBANES. Well, it seems to me they obviously do. I'm just a little struck by this assertion that the banks are sort of prepared to put up whatever is negotiated. I mean, the banks have a position in the beginning, don't they?

Mr. GUENTHER. Well, the banks have often argued with the amounts that we are requested to put up, but we have never developed an alternative and we felt it was important to keep the World Bank and the IMF and all parties involved. We felt that Mexico probably only needed \$4 billion rather than the \$7 billion that the IMF suggested. The IMF was very anxious to help Mexico rebuild its international reserves, so it incorporated in the amount that the IMF asked the banks to come through was not only an amount to finance the balance of payments gap but to rebuild the reserves to the level of a year or so ago.

So, no, the banks often argue with these numbers, but they have never failed in the end to come up with the numbers.

Senator SARBANES. All right. Mr. Coltman, I have one quick question of you. There have been some proposals for an international facility that would be willing to take the debt from the

banks at a discount and then pass that discount on to the debtor countries.

At the moment, there is this secondary market and I gather you have used it to some extent to dispose of some of the debt that you're holding.

Mr. COLTMAN. Yes, Mr. Chairman.

Senator SARBANES. But, of course, the purchasers from you then don't discount—I mean, they hold it at its face value so the debtor country gets no benefit out of this.

DISPOSAL OF DEBT AT A DISCOUNT

Now there are some practical problems in working this out, but what's your view on the notion of some way of the banks being able to dispose of the debt at a discount to a facility and then the facility passing that discount on to the debtor countries as a way of drawing down some of the overhang of the debt obligation and easing their debt servicing position?

Mr. COLTMAN. If you would permit me to avoid trying to answer exactly how that would work, I do endorse the concept because I think it's very important that we have a strong secondary market for that debt. As you point out, Mr. Chairman, at the moment, it would appear that most of the buyers seem to gain the benefit for themselves. If there's a way that could be transferred to the countries, we would be in support of it.

To us, we're not looking for any kind of subsidy or bailout. What we're looking for is a market that perhaps more truly reflects the value of this debt.

Senator SARBANES. It's interesting—this doesn't go anywhere near this, but the Japanese now are planning to set up a special facility just of their own to take the debt from their banks. It doesn't do what I'm talking about, as I understand it, although how they would then use that company that would then be holding the debt remains to be seen and it opens up a lot of possibilities for them in terms of how they structure it in their dealing with these developing countries and it seems to me a development we need to watch very carefully.

I trespassed on Senator Gramm's time. I yield to you.

Senator GRAMM. Thank you, Mr. Chairman.

I would like to begin by giving you my conception of the history of Third World debt in Central and South America and its relationship to exports and imports, and I'd like for each of you to begin saying whether you agree with me or not.

First of all, exports rose in response to all the debt we were extended which funded most of the exports. As nations have moved toward trying to pay it back or service it, their exports have had to rise or their imports fall if they're going to pay for it. And what we're seeing here is a tracking of our trade balance with these nations—a tracking of that balance with their debt position in terms of loans being extended and debt being serviced. In fact, for a nation to service debt and ultimately to pay it off it has to have a trade surplus.

Do you agree or not agree with that?

Mr. GUENTHER. Yes, I certainly agree with that. The sum of all trade surpluses in the world is always zero in the sense that someone's trade surplus is someone else's trade deficit, and you would expect over time that the people who have interest payments to make on the debt would have the trade surpluses and the people that are receiving interest would have the deficits, but—

Senator GRAMM. In fact, would you go further by saying that the trade balance, including services plus the capital balance, for all nations at all times must be equal, with our market with a flexible exchange rate that is functioning?

Mr. GUENTHER. That's right.

Senator GRAMM. So you would agree that the assertion, this idea, that somehow we're going to run a trade balance with Central and South America and they're going to service their debt, is ridiculous, that in fact to mandate that nations don't run surpluses with the United States, if those nations are debtors, is to assure that those debts can never be paid.

Do you agree with that?

Mr. GUENTHER. Yes, to assure that the debts can never be repaid in the sense that their debts will not go back to zero 20 or 30 or 40 or 50 years from now. I assume that Citibank's balance sheet will be twice as big 50 years from now as it is now or 10 years from now as it is now, and all of our customers, whether it's McDonald's hamburger or General Motors or customers in Brazil, will probably owe us more 25 years from now than they do now. So it's not a question of debt being repaid in any macro sense. It's a question of the level of the debt growing at some reasonable amount.

But if the purpose were to get the debt repaid in a macro sense, certainly you would have to do it that way.

Senator GRAMM. Well, if you've got a nation—I want to go on to other people before they forget the question. If you're like me, if somebody asks me two or three questions, by the time I get to the second and third one I've forgotten it.

But if you look at a nation like Brazil that's got a huge debt, just servicing that debt—just paying interest on it requires that they have a trade surplus of about \$10 billion a year. Is that not right?

Mr. GUENTHER. Yes, that is right.

Senator GRAMM. So that when the House of Representatives is targeting nations saying, as we had a bill a couple of years ago that in fact targeted Brazil when they had an \$8 billion surplus, you would say that the adoption of a bill that would impose trade sanctions against Brazil when it had an \$8 billion surplus, when it takes \$10 billion to pay interest on their debt, is a guarantee for default?

Mr. GUENTHER. I would, unless if they had no capital inflow. Now I have said that I think if Brazil had to pay all of its interest out of its trade surplus and it did that for 2 or 3 years, Brazil had \$13 billion and \$12 billion trade surpluses in 1984 and 1985 which exceeded their interest bill. So they were completely paying their interest bill out of a trade surplus and had something left over. That would seem to me almost beyond the call of duty in the case of a Brazil, but if you were going to pay Brazil's interest completely out of the trade surplus right now, you would need to run about an \$8 billion trade surplus.

Now I would think it is reasonable to expect, though, that Brazil would receive some capital net—and here I think Ms. Shelton-Colby and I are using the word “capital” differently. I would think this is a capital-short country and will remain capital-short in the future in the sense that it’s got some good investment projects that exceed its own ability to generate internal savings.

To the extent it receives new capital in the sense of net new loans, it would not need to run that large a trade surplus. And it has been receiving some net new loans.

Senator GRAMM. Mr. Colman?

Mr. COLTMAN. I would comment that clearly the classic description for a country facing difficulties in debt repayment is to reduce imports, is to expand exports, and inevitably that’s going to have an impact on all of the developed countries that historically have done business with them.

I would agree, though, with the point made earlier from this table that the deficits that existed in the late 1970’s are really unsustainable. Nevertheless, I would have to agree with the point.

Senator GRAMM. Would you say they were funded by the loans we were making, that in fact we were, through our lending policy, allowing them to run these trade deficits and some of these trade deficits—many of them—were with us.

Mr. COLTMAN. There were certainly excessive lending that occurred on a worldwide basis to these countries. That’s some of the price that we’re paying now.

Senator GRAMM. Ms. Shelton-Colby?

Ms. SHELTON-COLBY. Senator, to the extent that I can remember the original question, I think I agree with you.

I don’t want to either defend or criticize the banks. I’m just trying to be as objective as I can in my evaluation.

PETRODOLLARS AND BANK LOANS

I think it is important to point out that in the mid to late 1970’s there was an enormous amount of pressure put on the banks to recycle those petrodollars that were building up as a result of the oil price increase. Latin America was a logical place to look since for the previous quarter of a century it had been growing at rates of 6 to 8 percent—some countries even higher than that. Brazil and Mexico were growing at 10 to 12 percent.

So there was pressure from governments on the commercial banking sector to rechannel these petrodollars.

All that being said, I think I agree with you. I was in the Government at the time and not in the banking sector, but I’ve heard a lot of horror stories about inadequate attention being paid not only to the economic merits of a particular deal but also to the political climate in the country in question.

So to some extent, I would agree that the lending helped to finance the imports from the United States.

One other element we haven’t mentioned this morning that I think is important when we try to evaluate the relationship between debt and trade is the overvalued dollar. I’ve looked at some studies that the Joint Economic Committee and the International Trade Commission have done on this issue and they, of course,

come to the conclusion that debt has taken a terrible toll on U.S. exports. As I've indicated, I basically agree with that. But I do think that part of the problem has been the overvalued dollar which theoretically should be corrected by its decline over the past few months.

If I may make just one last point, I think those of us who work on the debt sometimes get a little worried about the debt per se. There's nothing really inherently wrong with debt. We've all got some degree of debt or another.

The problem occurs when you can't service it and have some capital left over for growth. I think you were not yet in the room when I mentioned a figure which to me sums up the whole issue. Last year Latin America paid 5.3 percent of its GDP in interest to the banks. Its trade surplus amounted to 2.3 percent of their GDP. So they are dipping into savings and into reserves which have plummeted—not in all countries, but in many. So again, to sum up, there's just not enough money left over for growth and I would add, the climate internationally for new foreign investment is very poor. Latin America is no exception.

Last year, in Brazil, for the first time in many, many years, there was net disinvestment by multinationals.

Senator GRAMM. Well, I think basically what we're seeing here is a recognition that exactly as you're saying—we were a net debtor nation from the time the first pilgrim stepped on Plymouth Rock until 1922 and we sustained the most rapid period of economic growth in the history of mankind. It's what you do with the money. It's like your banks are net creditors and you wish like hell you weren't to some of the people you've loaned money to. It depends on what they did with the money.

Well, let me make my final point and ask for your response to it.

I've tried to look at what the role of this committee and the role of the Congress ought to be on this Third World debt issue. My view is that it's not our business to come in and try to make the banks whole. It's not our business to be setting up corporations to take this debt off your hands and hope to negotiate it out.

It seems to me that it's long overdue that we take action to protect the domestic banking system. Chairman Proxmire and I will today introduce a bill that requires general reserving against troubled loans in the amount equal to one-tenth of the difference between the value you're carrying those loans on your books and the estimate by the regulators of the actual value of the loans. It would require the banking system over ten years to build up its reserves. It would direct the regulators to recommend action to eliminate the current restrictions against debt-equity swaps, and it would take other actions to try to deal with the Third World debt problem, which as I view it is very akin to a corporation that's trying to grow only with debt and without equity.

That would promote, Mr. Coltman, your secondary market, only it would be a free market because now if you're holding Third World debt and it's counting like IBM bonds on your balance sheet, even though it may be selling at a very small secondary market for 50 cents on the dollar, you don't have much of an incentive to take 50 cents for it.

On the other hand, when you have to begin reserving against it, you're going to have a real incentive to look at whether you want to sell that on the secondary market or not.

Now from the point of view of the nation, obviously not your individual banks, tell me what you think is wrong with that policy.

Let me start with you, Mr. Guenther, and then my time is up.

Mr. GUENTHER. Well, I would agree with you on the first point. Mr. Coltman seemed to suggest that if we had this agency perhaps it would pay him a little higher price for his debt when he sold it than he's getting now. A small bank certainly can sell in the market and it would bother me for all sorts of reasons if an agency were set up that in some way looked like a free lunch, it looked like a free lunch either to the banks or others, that it might buy from the banks at a little higher price or something. So I would be concerned about the negative feedback of that in the sense of bank bailouts and that sort of thing which cause us a lot of problems.

REAL WORTH OF LOANS

As to the scheme of if you have a loan that is not worth what you're carrying on your books, it is my view that it should be written down and I'm not sure you should write it down over 10 years; you should write it down faster than that.

The question comes—what are these loans really worth? The question on Brazil—somebody mentioned Brazil—really, where is Brazil going to be 20 years from now? What's that loan worth? My own assessment would be that probably Brazil is one of the stronger developing countries, but I'm talking about a 20-year look out there and what happened the last 4 or 6 weeks in Brazil is a ripple on the surface compared with the 20-year view. And certainly if one takes a short-run view, all the news out of Brazil is going to be bad for several weeks.

But the question then is, what do you do with that loan you've got on your books on Brazil? Your statement that the regulators should try honestly to make an assessment of what it's worth, I think that is true. It's very difficult to do. Therefore, most banks in trying to be prudent have not attempted to say, "My Brazil loan is worth this, my Mexican loan is worth this, and my Nigeria loan is worth this, and my loans in Texas are worth this," but have built up a general loan loss reserve to meet the problem wherever it comes. And we and other banks have been building that up very rapidly. I think our general loan loss reserve has tripled in 2 years.

The one big member of the big eight, Continental Illinois, that really had serious problems, had the lowest ratio of loans in Latin America of any one of the big eight. So you can have loan problems other places, including the United States Midwest, that hit you. And our position has been to build up the general loan loss reserve rather than attempting to say each individual country is this much.

Mr. COLTMAN. I would comment that Mr. Guenther and I probably do agree that the value of debt that's now being sold out in the market may not be its ultimate real value. My feeling is that it may well be higher. We do not have a particularly efficient second-

any market out there. As a bank that has been actively using it, that's our opinion.

Any agency that could help organize that to a greater degree would be positive, but I would totally share your opinion, Mr. Guenther, that none of us are looking for any kind of bailout or public funds in any way in solving this issue.

As far as the issue of write-downs, I think each individual bank has looked at their portfolios and made those judgments as to what the values are of these loans. Those of us who have valued them less have been selling them into the market and have created a very specific loan loss reserve. I have no problems with the basic thrust of what you're proposing, Senator.

Ms. SHELTON-COLBY. Senator, obviously I've not seen your legislation. Based on your description of it, I think it's a step in the right direction.

As Jack Guenther pointed out, Citibank and most other banks have substantially increased their loan loss reserves over the last few years and I think 1987 and 1988 are going to be years of continued major reserving. This kind of legislation is a further inducement to continue that pattern.

I'm going to take a little bit different position on the discount facility from that of my colleagues. I support the idea. I was initially a little ambivalent about the idea because if you rely solely on the secondary market I can't see that you are providing much debt relief to the debtor; that is what I am most worried about—getting some kind of debt relief, reducing the annual debt service burden—because, as I said earlier in my remarks, I fear that unless the creditors take the initiative to provide debt relief, the debtors are going to take the initiative.

I think the Brazil situation is potentially a very, very serious one. So if I understand the idea of the debt facility correctly—and I know there are many "i's" that need to be dotted and "t's" that need to be crossed plus the whole question of capitalization is one that worries me—it could be a way of reducing the debt service burden and therefore is an idea worth pursuing.

Senator SARBANES. Senator Heinz.

Senator HEINZ. Thank you.

BANK TRADE FINANCE

I want to pursue some of the issues Senator Gramm is pursuing but I want just to get your views on one rather concrete issue first and that is the extent to which the generic problems of debtor countries dries up bank trade finance to those countries.

There are some people who suggest—and I know Philadelphia National Bank has made a special effort over the years to engage in the safest kind of international debt transactions—namely, trade transactions which are usually tied or secured in some way—but is it or is it not the case that when a country gets in overall debt difficulties that its trade finance dries up?

If it does, obviously it has very severe employment and export consequences for the United States.

Mr. Guenther, is it possible to in effect loan on a two-track system or does trade go down the tube when the country's credit rating precedes it?

Mr. GUENTHER. Well, I would have to give a mixed answer. Many countries historically when they got into debt service problems have tried to keep paying the trade credits and let their payments lag on the others and, therefore, if you are confident that that might happen you might be willing to go ahead with it. Nigeria has been a country that's done the opposite. Nigeria over the years has made a strong effort to continue making payments on its syndicated government debt and it's let arrears develop on the trade credits. So one would get quite worried when that happened.

As a general rule though, people's payment record has been a little better on the trade credit than on others and therefore each creditor has to make the decision whether he's confident enough that maybe this will continue to be serviced whereas the other is not.

Now you mentioned that if it's secured in some way. If your trade credit is really secured in some way, then you're not lending to the country at all so you have no problem. There's been a lot of talk of Peru still getting trade credit. Peru has to put up collateral in the United States to get an LC these days. So their own international reserves are tied up guaranteeing the LC. That type of trade credit is really not trade credit at all. That is advancing money.

Senator HEINZ. Mr. Coltman, do you generally agree?

Mr. COLTMAN. Senator, generally I do. I would say that when a country starts to get into balance of payments difficulties, all debt is impacted, whether it be short term, trade related, or not. Once we look at a country and are dealing with a problem, then one's concern is that the limited foreign exchange that the country has access to may well go to pay interest on that older debt and won't be available in the future to keep the new voluntary trade finance current.

And until that's very clear, I don't see that a lot of new lenders will return to that market.

Senator HEINZ. Ms. Shelton-Colby.

Ms. SHELTON-COLBY. Trying to look back over the last five years, I think generally the banks have maintained short-term credit in terms of trade lines as well as interbank lines in most cases, with the exception of Peru where they have been cut.

I do think it might be relevant, however, to point out that the banking community is not a monolithic bloc and the regionals do not necessarily always agree on these issues with the money center banks; there are even differences among the regionals. There are some regionals which just want out altogether. They don't want to hear of sovereign lending; they don't want to hear of short-term trade lending. Other regionals really want to get out of the sovereign lending and go back to short-term lending only because they perceive the risk is less. I think there are also some regionals who really very much want to stay in the ballgame. So it really varies according to the bank.

Senator HEINZ. Let me go back and deal with the issue of how we should recognize the troubles of the countries that are neither

good credit risks nor that we rate as value impaired—the other transfer-risk problem countries.

Senator Gramm and Senator Proxmire have made a very concrete proposal. You've said it has some promise.

One alternative to what Senator Gramm has proposed, which is a 10-year process of loan loss reserving, measuring the difference between book and market based on that, is to have a somewhat softer approach wherein the regulators would either say or whisper that within the OTRP category there are really two groups of countries, those that are fundamentally OK and they have more of a liquidity problem, and others that have more of a solvency problem. And with respect to the latter, rather than requiring actual loan loss reserves, one would simply require the banks that are lending to those countries to do more in the way to increase their capital.

Two questions. One, is that not as good as or is it worse than what Senator Gramm has proposed? Second, why?

Let me start with my constituent, Mr. Colman, on that.

Mr. COLTMAN. They both certainly have merit. I think the one problem that I see with the writing down to market over a 10-year timeframe relates to what is market? It's a difficult judgment as to what is market because I just don't believe that the prices we see out there truly reflect long-term value.

LIQUIDITY OR SOLVENCY

The other issue relates to, do we regard a country that has gone through 6 years now of temporary liquidity rescheduling as just being that? I think that probably you need a general basket to cover those where you're really not quite sure whether it's liquidity or solvency.

Senator HEINZ. I'm really proposing bifurcating the other transfer risk category countries into kind of the "haves" and the "won'ts."

Mr. COLTMAN. That would be a very difficult judgment for the regulators to make.

Senator HEINZ. Sure. They have to make it now on the value impaired category.

Mr. COLTMAN. Our own approach is to look at all countries going through these difficulties and start to put some specific reserves against them as well as the general basket. That's our own internal approach.

Senator HEINZ. Mr. Guenther, what do you think?

Mr. GUENTHER. Senator, they do look at it now but 2 or 3 years ago when this system was set up—and I think in connection with the IMF bill a couple years ago the regulators were asked to spell out what types of factors they would take into consideration in putting a country into value impaired and so forth. It is not so much their guessing which country will really have trouble 5 or 10 years out there as it is at looking whether they are in fact servicing their debt now.

So the countries that are in the value impaired category now—and I guess this is fairly public, the Bolivias, the Nicaraguas, the Sudans, the Zaires—are countries that haven't really paid interest

on their debt for a couple of years and that's why they're in there. It's not someone's guess.

Senator HEINZ. They are clear basket cases.

Mr. GUENTHER. Yes. Those are what they would say there's no question on those, but that the loan is value impaired and one should take a specific write down on those.

On the others, I'm sure the regulators have debated among themselves and I think Mr. Bench from the Comptroller is coming in tomorrow and it's certainly debated within banks as to whether it is better when you are guessing where a country will be 5 years from now whether it is better to try to guess whether it will be Indonesia or Mexico or——

Senator HEINZ. Let me try and focus what we're talking about here. Both Senator Gramm's and my proposals have certain strong points and certain weaknesses. The weakness of Phil Gramm's approach is that the secondary market is untested and weak and we've had some experience selling off Exim Bank loans and Federal Rural Housing loans that makes us a little nervous—his conception philosophically is very good. I find it very difficult to argue with him philosophically.

But as we found out, it's hard enough meeting the Gramm-Rudman target in 1990 and 1991, which is a lot less pure, let me tell you, than the balanced budget amendment. That amendment is philosophically even purer, it just takes a while to get there. And he's not adverse to a balanced budget, let me tell you. I refer to my distinguished colleague from Texas.

Senator GRAMM. Would the distinguished Senator yield for just 1 second?

Senator HEINZ. I'd be happy to yield.

Senator GRAMM. I just want to make it clear that my bill with Senator Proxmire sets out seven criteria for assessing the difference between book value and actual value, and only one of the seven is what you're actually selling them at on the secondary market. Other things have to do with the longer-term assessment you're talking about, whether they are servicing their debt, what their export history has been, what their history of servicing has been. So it's seven things, not just one.

Senator HEINZ. Well, I'm disappointed to hear that Phil Gramm has put into the hands of Federal bureaucrats another judgment. I never thought I would live to see the day where he would trust anybody in Washington, DC in the executive branch to do something like that.

Senator GRAMM. I'm going to be looking over their shoulders.

Senator HEINZ. Well, that's the only mitigating factor that I can see, in which case his approach and mine are very similar because rather than have the bureaucrats second-guess every loan, I would have them second-guess countries, and that's the main difference between our approaches. We both, unfortunately, put bureaucrats in here because we aren't confident that there is a market yet on which to rely.

JUDGMENT OF BUREAUCRATS

Now try this really briefly. Which is it better to have—trust the bureaucrats—understanding no one trusts bureaucrats unless they're us, is it better to trust them on countries or on loans? We'll start with Ms. Shelton-Colby.

Ms. SHELTON-COLBY. Senator, I wonder if I might respectfully dodge the question. I am not a banker. I am a political and economic analyst. So if I may, I'll defer to my two colleagues.

Senator HEINZ. Next.

Mr. COLTMAN. I'd like to dodge it too, but I don't think I can since I'm a banker. It's a very tough one because inevitably in evaluating a country there are political considerations that occur and that sometimes affects judgments.

I would probably say that if you can define what are the characteristics of a country in trouble as defined by not being able to pay its interest bill and by having to have new money—if you can define that generally, then perhaps doing an overall basket might be the better approach.

Senator HEINZ. Mr. Guenther.

Mr. GUENTHER. Except for countries that are in such bad shape that we would all have no trouble agreeing that those should be in there, I would think it would be better not to try to identify the country but to build up a general loan loss reserve instead that could be used for any purposes.

Senator HEINZ. All right. Well, thank you all very much. Do you have a comment?

Ms. SHELTON-COLBY. Yes, I do, Senator, if I may. I think I tend to agree with this point. Countries have a funny way of changing both their political structure as well as their economic structures. In 1951, who would have predicted that South Korea would become the economic powerhouse that it is today? In 1930, who would have predicted that Argentina would become the economic basket case that it is today?

So I think you're skating on thin ice when you're trying to assess long-term political and economic trends in countries.

Senator HEINZ. I don't have the time any more to ask this question now, but for the record could you also think about whether Senator Gramm's approach or my approach would do more for the creation of a secondary market? I have the sense mine might, but I'm not sure I'm right or why. Thank you very much.

Senator SARBANES. I want to pursue this point because it's not quite clear to me how the approaches that have been suggested are going to get at the problem that I see, which puts American financial institutions and American producers at odds with one another. In other words, in the current situation, I think there's a perception that in order to meet their financial obligations the developing countries have to pursue economic policies the brunt of which is borne to a significant degree by American producers through loss of export markets and more intense import competition.

Now all of these ideas of a loan loss reserve and writing them down, the debtor country would still be left with the full extent of the obligation, would it not?

Ms. SHELTON-COLBY. To whom are you addressing that question, Senator?

Senator SARBANES. Well, anyone on the panel who wants to respond.

Ms. SHELTON-COLBY. That's my understanding of it.

Senator SARBANES. Is that correct?

Mr. GUENTHER. Yes, they would be completely different processes. Writing it down from a prudential standpoint would be a completely different thing from turning around and then saying, "OK, you're forgiven."

Senator SARBANES. So even if we created a secondary market to take the debt from the banks, if the secondary market then held it at its face value, the debtor country would not find its position improved in any way in terms of being able to move toward a better growth pattern. Is that correct?

Mr. GUENTHER. That's correct. And the Japanese scheme you mentioned has nothing to do with the second. It is strictly a way of getting tax relief for the banks from the write-down.

Senator SARBANES. Well, yes, but there are some of us who think that the Japanese may be thinking ahead. I mean, on the face of it, I think that's correct. But there are some of us who think that they may in fact be perceiving some of these things and that conceivably that facility will then be used by them in a very skillful way in terms of dealing with developing countries in terms of affecting trade flows and so forth. It's not inconceivable that that could happen. At the moment, it's only on the basis on which you're saying. But it's not inconceivable that that could happen and we could find ourselves even further behind the curve if that proved to be the case.

Mr. COLTMAN. Senator, I might make one comment on the secondary market. You're quite correct. It doesn't forgive principal at all, unless a couple of things might happen. We certainly have identified that some of the buyers in the secondary market are nationals from that country who are using funds that were part of the previous capital flight and who are buying that debt at the discount and gaining that advantage.

The other point, of course, is that some of it is being purchased on the secondary market in order to be turned into equity on debt for equity swaps, and that should be retiring the debt in that case.

Senator SARBANES. None of you seems to be as apprehensive as it occurs to me we should be about the debtor countries taking more and more extreme steps, except for Ms. Shelton-Colby. But the other two of you seem much more sanguine about that prospect than I think I would be. In other words, not that you necessarily would have a debtor cartel, but isn't the way we're dealing with it now just fraught with the very real danger that this could become a highly explosive political issue?

Mr. GUENTHER. People have feared that from 1982. Some people sort of feel that it's always going to explode or something. I have not felt that way. I have felt it was a long-term problem. In that sense, I very much agree with people that this is a long-term problem—not 50 years but 10 or 20, but I've never felt that it was about to explode or something. No, I don't feel that there's any indication that the situation has become more explosive or anything.

Senator SARBANES. You think the system can take these recurring crisis that we have and that there's no need to try and get this thing in some way regularized and on a track that you can say, well, now in a sense it can be worked out and we're on long-term tracks. At the moment, it's all sort of—at least I think there's a perception—moving from short-term crisis to short-term crisis.

Mr. GUENTHER. I think the system can not only take it; the system has always had a certain number of short-term crisis. Getulio Vargas shot himself in Brazil in 1951 over a financial crisis connected with Brazilian debt. The Brazilians rescheduled again in 1963 when Goulart went out. The Argentines rescheduled when Peron went out first in 1957. So the difference the last few years has been that it was more extreme because our recession in 1980-81 was more extreme and interest rates went to 14 percent.

So we've got too many of them right now, but the system is very much able to handle a certain number of them.

Mr. COLTMAN. I would comment and disagree somewhat with that assessment. I think we certainly see the fabric of the process being stretched. The conditions we see in many of the Latin American countries are something that do concern us. There is a chance that what you speak of could happen.

SUSPENSION OF DEBT SERVICE

Ms. SHELTON-COLBY. Senator, two comments. No. 1, we now have five countries in Latin America that have suspended debt service. Admittedly, three of those are small. The fourth is Peru and then Brazil. But five countries that have suspended debt service is I fear an indication of things to come.

And I remember last June, June 1986, when Mexico very quietly behind the scenes threatened the U.S. Government that it would stop servicing its debt unless Washington was able to get a much more generous arrangement for Mexico with its creditors. That was done.

Brazil has now done the same thing and I might add, unlike Mexico, Brazil is refusing to contemplate a traditional IMF program.

If the banks go along with Brazil—and I think some agreement will be reached with Brazil—but if the banks go along with a new money facility and a rescheduling for Brazil without an IMF agreement, I think this is a major setback in terms of the adjustment process and one that I would be very, very much opposed to. The system, yes, is able to handle a certain amount of crisis. But it is very, very serious to note that the world's second largest debtor, Brazil, is talking about taking unilateral action to reduce its debt service from 4 percent of GDP to 2.5 percent of GDP if Brazil does it and gets away with it, Mexico will be tempted to follow suit and so will Argentina. And then probably the others as well. That's an indication to me that there are some very serious creaks and strains in the system.

Senator SARBANES. Well, we thank the panel very much. We appreciate it. Your testimony has been very helpful.

If the next panel would come forward, we could proceed.

Gentlemen, we are pleased you are here. Mr. Pierce, I gather you may have to leave at some point. You are under some time constraint. Why don't we take your statement first? Then we will proceed with the rest of the panel and then we will go to the questions.

STATEMENT OF J.B.L. PIERCE, VICE PRESIDENT, THE BOEING CO.

Mr. PIERCE. If I may then, I'd like to go to the executive summary. The formal statement is submitted for the record.

Senator SARBANES. The full statement will be included in the record.

Mr. PIERCE. Thank you, sir.

My name is Jack Pierce. I am vice president of The Boeing Co., one of America's largest exporters.

The Third World market, prior to the debt crisis, was one of our fastest growing markets. And it remains an important market with an estimated demand for 691 aircraft, or \$57 billion by the year 2000.

The debt crisis has put pressure upon the Third World to increase their exports to repay outstanding debt and to decrease their imports of U.S. products to avoid the creation of further debt.

This hearing is very timely in the sense that we are here to propose action to strengthen the economies of the Third World and to promote U.S. trade.

Yet this week it is proposed to eliminate the Direct Credit Program of the Export-Import Bank in the Senate Budget Committee deliberations.

T. Wilson, our chairman, put it succinctly on a previous occasion when Exim was under attack when he said, "We are shooting ourselves in the foot."

For the reasons cited below, Exim needs maximum support by the U.S. Congress.

World trade continues to slow down. OECD growth rates are declining. The U.S. economy is weaker, and other "locomotive" economies such as Japan and Germany, which are highly export-dependent, also face reduced growth rates.

WORLD ECONOMY IS SLOWING

Morgan-Stanley's recent report, "Disinflation and the International Economy—the Theme of the 1980's," points out the key problem; namely, the world's total economy is slowing down as measured against previous business cycles.

Remember, it was a basic assumption that OECD growth rates had to be maintained at least at a level of 3 percent real growth in order to resolve the Third World debt crisis. Such minimal growth rate is not happening.

The slower OECD growth rates create intense export competition. Despite recent devaluation of the dollar among key European currencies and in Japan, the J-curve impact on U.S. trade is lasting a painfully long period. The dollar devaluation is not as effective as envisioned.

Much of the U.S. industrial base moved abroad during the long period of the overvalued dollar to more favorable cost centers, oftentimes with superior export promotion programs.

As recently reported in the Wall Street Journal, there is now substantial worldwide overcapacity in many industrial sectors. Because of past investments overseas, many foreign suppliers remain extremely price competitive due to having sunk investments into such facilities.

For example, despite impact of revalued European currencies, we can testify to the aggressive pricing and financing policies of Airbus Industrie, a multigovernment owned European consortium which seems impervious to profit orientation and, of course, has received substantial subsidy support from inception.

No financial statements are issued by Airbus so we cannot gauge precisely how much such subsidies have cost the Governments of France, Germany and the United Kingdom—and their taxpayers. However, even the Europeans concede the amounts are substantial.

The ideal resolution to the Airbus dispute would be to witness the privatization of Airbus and clear visibility of its capital allocation. After all, just how many years of constant subsidization is necessary? Either a commercial enterprise becomes successful after initial multigovernmental support or it has basic problems of efficiency.

By facing the market-driven forces through privatization of Airbus, more efficient use of resources would occur within the European Economic Community. The period of sustaining Airbus by constant infusion of government support seems to be extending beyond unreasonable time by any measurement.

Stifling of imports through "protectionism" only invites retaliation.

Examining the events of the late 1920's and the early 1930's, we have the choice to avoid the pitfalls of the past.

Geoffrey Bell of International Reports, Inc. recently indicated, "The Baker plan is manifestly dead." Perhaps this is an overstatement.

However, Bell stated:

In reality, more and more banks are trying desperately to avoid lending any new moneys. Voluntary lending from banks or capital markets is virtually nonexistent and the old semi-unison amongst banks in making involuntary loans is rapidly falling apart.

Commodity prices in real terms are at their lowest point in 50 years. The depression in commodity prices is one of the main reasons why the underlying assumption of the IMF, the central banks and the commercial banks in 1982-83, that the debt crisis was only one of temporary liquidity, has turned out to be so completely wrong.

The combination of low commodity prices and a lack of new money is a recipe for disaster. Something must be done soon.

Commercial banks have reached maximum points of tolerance regarding Third World country risk.

The current mark of deterioration of the current market value of Third World debt is clearly evident in a survey conducted by Shearson Lehman Brothers as to the secondary market valuation of outstanding loans.

Action items can be taken now by the Congress to relieve the Third World debt situation and, simultaneously to promote the increase of trade and investment with the Third World.

As Fred Bergsten, executive director of the Institute for International Economics, once said, "Exim Bank is the cutting edge of U.S. trade policy." This is patently self-evident.

EXIMBANK AND U.S. EXPORTS

For all the reasons previously stated—the slowdown in world trade, aggressive foreign competition, commercial banks reaching maximum country risk exposure, and deterioration of outstanding Third World debt which closes off further capital markets—Exim is critical to facilitate U.S. exports.

Yet recent actions by both OMB to add further restrictions to the Exim guaranty program and the proposals in the Senate to eliminate Exim direct credits are counter-productive at just the wrong moment.

The second point would be to encourage Exim to develop aggressive programs. Exim can enhance the ability of U.S. exporters to increase exports of their products through more imaginative export programs such as leasing.

We continue to export our credit to Third World airlines using more complex methods of leasing by selling aircraft to trustees or lessors located outside of the particular Third World country who, in turn, lease or "rent" the aircraft to the Third World airline. By using leasing techniques where title does not pass and the aircraft are "rented," not sold, to the Third World airlines, we have been able to stay clear of the problems associated with reduction of existing external debt outstanding. The transaction, in essence, is kept off the country balance sheet.

Here, Exim has been very critical where true leasing is established under the design of what we call an international equipment trust, where the trustee or lessor provides the use, the rental of new aircraft sold to the trust to be operated in the Third World airline. Exim is critical to improve leasing techniques in the Third World market.

The third action point would be to strengthen Exim's role in Third World debt management.

Bill Cline, senior fellow, Institute for International Economics, recently testified as to this point.

The fourth action is to support the World Bank's MIGA program. Portions of the Baker plan need to be kept alive now at minimum. One critical point relates to the commitment of the United States to support World Bank's MIGA, or Multilateral Investment Guaranty Program. This program provides political risk insurance against expropriation, war risk, and inconvertibility, which is becoming more important in the Third World.

We have discussed with the World Bank the growing importance which private leasing companies are playing to support the development of Third World air transportation by renting new fuel-efficient aircraft. The World Bank MIGA program providing political risk insurance against expropriation and inconvertibility would augment leases to the Third World airlines greatly.

Encouragement of private investment inflow back into the Third World is critical. The World Bank's MIGA program requires an initial subscription of only \$44 million by the United States and that

is one very "fast-track" method to encourage private capital inflow to the Third World. This program would do much to stabilize and to reverse the incredible flow of flight of capital from the Third World.

We need action and not further debate. The Third World debt crisis is of much longer duration than was anticipated in 1982.

A more permanent program needs to be put in place now. The recent moratorium declared by Brazil should make it clear that the debt-service burden is becoming intolerable. In fact, our international economic security is in jeopardy.

A host of proposals have been advanced which offer more "permanency" or stability for the Third World nations. Such programs recognize the debt crisis is here to stay for a long time.

It is interesting to note that the Japanese have set up a Cayman Island facility to act as the general collector for certain high-risk sovereign debt. According to Business International, it would operate essentially as a factoring company and buy the debt from banks at a discount. Such action may place Japanese banks and companies in a stronger competitive position and provides new impetus to the secondary debt market.

The Japanese know how to "work a problem" effectively. We might learn from them. In fact, our experience has been that the Japanese banking community is one of the most aggressive and supportive sectors of export financing of U.S.—I repeat—U.S. produced aircraft, and that spells jobs and U.S. exports.

While others talk, they act. There's got to be a lesson there.

Thank you, Mr. Chairman.

[The complete prepared statement of J.B.L. Pierce follows:]

BOEING

Statement

J.B.L. Pierce
Vice President - The Boeing Company

United States Senate Committee on Banking, Finance & Urban Affairs

Subcommittee on International Finance & Monetary Policy

"Developing Countries' Debt - and Impact On U.S. Trade"
April 1, 1987

Thank you, Mr. Chairman. My name is Jack Pierce and I am Vice President of The Boeing Company - one of America's consistent major exporters.

The Third World market - prior to the debt crisis - was one of our fastest growing markets. It remains an important market with estimated demand for 691 aircraft - or \$57 billion - by the year 2000.

The debt crisis has put pressure upon the Third World to increase their exports to repay outstanding debt - and to decrease their imports of U. S. products to avoid creation of further external debt.

Last year, we testified at another Congressional committee as to the impact of this Third World debt crisis upon the flow of U. S. Trade. We proposed how to adjust U. S. and World Bank programs to encourage the free flow of trade - and to avoid the growing trend toward protectionism. We resubmit this previous statement in addition to current testimony for the record - as reference point.

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"Shooting Ourselves in the Foot"

This hearing is very timely. We are here today to propose action(s) which strengthen the economies of The Third World - and to promote U. S. trade with such nations.

Yet - within the last week - it has been proposed to eliminate the Direct Credit Program of The Export-Import Bank of the United States in Senate Budget Committee deliberations.

T. Wilson - our Chairman - put it succinctly - on a previous occasion when he testified on behalf of EXIM - and EXIM was under attack. He said:

"We are shooting ourselves in the foot ..."

For the reasons cited below - EXIM needs maximum support by the U. S. Congress.

O.E.C.D. Growth Rates - Slower Than Previous Cycles

World trade continues to slow down. OECD growth rates are declining - even *more* than last year. The U. S. economy is weaker - and other "locomotive economies" - such as Japan and Germany - highly export-dependent economies also face reduced growth rates.

Morgan-Stanley's recent report - "Disinflation and the International Economy - the Theme of the 1980's" points out the key problem - namely, the world's total economy is slowing down - as measured against previous business cycles:

GNP Growth: Current Versus Prior Business Cycles			
	1966-1973	1974-1979	1981-1986
Europe	4.6	3.3	2.2
Germany	4.1	3.9	2.3
France	5.5	3.9	1.4
United Kingdom	3.1	2.7	2.6
Italy	5.4	3.9	2.5
Japan	9.4	5.1	3.7
Canada	5.5	3.9	3.7
United States	3.5	4.1	3.9

*Includes years 1982 to 1986. *Includes years 1984 to 1986.

Source: Organization of Economic Cooperation and Development.

Remember - it was a basic assumption that OECD growth rates had to be maintained - at least at a level of 3 percent *real* growth - in order to resolve the Third World Debt crisis. Such minimal growth rate is not happening.

The slower OECD growth rates creates intense export competition. Despite recent devaluation of the dollar - among key European currencies - the J-Curve impact on U. S. trade is lasting a painfully long period. The dollar devaluation is not as effective as envisioned.

Much of the U. S. industrial base moved abroad during the long period of the over-valued dollar - to more favorable cost centers - oftentimes with superior export promotion programs.

Aggressive Foreign Competition

Furthermore, as recently reported in The Wall Street Journal - there is now substantial worldwide over-capacity in many industrial sectors. Because of past shifting investments overseas, many foreign suppliers remain extremely price competitive due to having sunk investments into such facilities.

For example, despite impact of revalued European currencies - we can testify to the aggressive pricing and financing policies of Airbus Industrie - a multigovernment-owned European consortium - which seems impervious to profit orientation and - of course - has received substantial subsidy support from inception.

No financial statements are issued by Airbus - so we cannot gauge precisely how much such subsidies have cost the governments of France, Germany and the United Kingdom - and their taxpayers. However, even the Europeans concede the amounts are substantial.

The ideal resolution to the current Airbus dispute would be to witness the privatization of this entity - and clear visibility of its capital allocation. After all, just how many years of constant subsidization is necessary? Either a commercial enterprise becomes successful after initial multigovernmental support - or it has basic problems of efficiency.

By facing the market-driven forces - through privatization of Airbus - more efficient use of resources would occur within the European economic community. The period of sustaining Airbus by constant infusion of government support seems to be extending beyond unreasonable time - by any measurement. Hopefully, it is the European Establishment, itself, which will realize Airbus has reached the point of maturity to stand on its own feet. I find it difficult to believe that the European investment banking community - which has been instrumental in many privatization programs recently - would not be able to develop a meaningful privatization program to the mutual benefit of all - including Airbus management, itself, which would gain a greater level of managerial control.

Export Promotion - Not Protectionism

The first step, then, is to preserve our export-promotion programs . . . especially EXIM from any further erosion.

Stifling of imports through "protectionism" only invites retaliation.

Examining the course of event of the late 20s and early 30s - we have the choice to avoid the pitfalls of the past.

Revisiting The Baker Plan

Geoffrey Bell of *International Reports, Inc.* - in his March 20th commentary - indicated - "The Baker Plan is manifestly dead." This is perhaps an overstatement, of course, however:

Bell stated (excerpts):

"In reality . . . more and more banks are trying desperately to avoid lending any new monies . . . the stark reality [is] that since 1982 South America has transferred almost US\$100 billion on a net basis to industrial countries through interest and amortization payments after taking into account new money inflows . . . such a massive outflow cannot continue indefinitely. Yet, voluntary lending from banks or capital markets is virtually nonexistent; an old semi-union amongst banks in making involuntary loans is rapidly falling apart.

Commodity prices in real terms are at their lowest point in 50 years. There is little or no chance that a quick burst of commodity price inflation will bail out debtors and creditors through a sharp increase in export earnings . . . the depression in commodity prices is one of the main reasons why the underlying assumption of the IMF, central banks and commercial banks in 1982-83, that the debt crisis was one of temporary liquidity has turned out to be so completely wrong.

The combination of low commodity prices and a lack of new money that has lasted for almost five years is a recipe for disaster. Something must be done soon. . ."

Commercial Bank Exposure

Commercial banks have reached maximum points of tolerance regarding country risk. *The Economist* of March 21 stated:

"Banks have all but stopped voluntary lending to the shakier third-world debtors . . . American banks' new lending to LDCs fell by 2% in 1984 and 7% in 1985, after having risen by 19% a year in the five years through 1982.

Exposure in Latin America

Bank	Mexico	Brazil	Argentina	Venezuela	TOTAL	% of primary capital ^m
		(\$ billion)				
Citicorp	2.8	4.6	1.4	1.1	9.9	80
BankAmerica	2.5	2.7	0.4*	1.3	6.9	95
Manufacturers						
Mariner	1.9	2.2	1.5	1.0	6.6	126
Chase Manhattan	1.6	2.8	1.0	1.2	6.6	101
J.P. Morgan	1.2	1.9	0.9	0.4*	4.4	69
Chemical	1.5	1.4	0.4	0.7	4.0	93
Midland	1.9	2.0	0.9	0.8	4.6	84
Lloyds	1.7	2.0	0.8	0.6*	5.1	90
Barclays	1.1	0.7	0.6	0.3	2.7	37

Americans at Dec 30 1986. British at Dec 31 1985. *see "see British, about new equity, primary and specific provisions".
Sources: Smith Barney; Island Lunch; Q&A; Barclay; American.

Deteriorating Value of Third World Debt

One way to measure the deterioration of Third World debt situation is to analyze the current market value of Third World Debt - as a percentage of the original face value. A recent survey by Shearson Lehman Brothers confirms such deterioration:

Indicated Market Selling Prices for Developing Country Debt
(As A Percentage of Face Value, First Day of Each Month)

Country	July 1983	January 1984	July 1984	January 1987	February 1987	March 1987	March 1987
Argentina	60	62	63	62	62	62	61
Brazil	75	75	73	74	73.5	68	63
Chile	65	65	64	65	66	66	66
Colombia	81	82	80	NA	86	86	86
Ecuador	65	68	63	63	62	62	58
Mexico	80	69	56	54	56.5	57	57
Peru	45	25	18	16	16	16	16
Philippines	NA	NA	NA	72	72	72	70
Poland	55	50	42	41	41	41	42
Romania	85	91	86	86	86	86	86
Venezuela	81	80	75	72	72	72	72
Yugoslavia	74	78	75	77	77	77	77

Source: Shearson Lehman Brothers Loan Transaction Group

Some action items can be taken now by the Congress to relieve the Third World debt situation - and, simultaneously, to promote the increase of trade and investment with the Third World.

ONE: SUPPORT BASIC REQUIREMENTS OF U. S. EXIM

As Fred Bergsten - Executive Director of the Institute for International Economics - once said - "EXIM is the cutting edge of U. S. trade policy." This is patently selfevident.

Yet, recent action(s) by both OMB to add further restrictions to the EXIM Guaranty program - and the proposal - in the Senate - to eliminate EXIM Direct Credits - are counterproductive at just the wrong moment.

TWO: ENCOURAGE EXIM TO DEVELOP AGGRESSIVE PROGRAMS

EXIM can enhance the ability of U. S. exporters to increase exports of their products through more imaginative export programs - such as leasing.

Leasing

We have continued to export aircraft into Third World nations - using more complex methods of leasing - by selling aircraft to trustees/lessors - located outside of the particular Third World country - who, in turn, lease - or "rent" the aircraft to the Third World airline. By using true leasing techniques - where title does not pass - and the aircraft are "rented" - not sold - to the Third World airlines - we have been able to stay clear of the problems associated with reduction of existing external debt outstanding. In essence, since the Third World airline only "rents" the aircraft - and does not, in fact, buy the aircraft (and take title) - the transaction, in essence, is kept "off COUNTRY balance sheet." The EXIM has been very helpful - in certain cases - where true leasing can be established under the design of what we call an International Equipment Trust - wherein the trustee, as lessor, provides the use - the rental - of new aircraft sold to the Trust - to be operated in the Third World airline. EXIM is critical to improve leasing techniques in the Third World market.

THREE: STRENGTHEN EXIM'S ROLE IN THIRD WORLD DEBT MANAGEMENT

Bill Cline, Senior Fellow, Institute for International Economics - recently testified:

"The perception that U. S. exports and employment could expand as the result of improved conditions in debtor countries is valid. The proper way to obtain this outcome is to greatly increase the level of activity of the U. S. Export-Import Bank in lending to debtor countries, and to encourage the export credit agencies of other industrial countries to do the same thing. . ."

FOUR: SUPPORT THE WORLD BANK'S "MIGA" PROGRAM

Reversing Capital Flight - World Bank's MIGA

Multilateral Investment Guaranty Authority

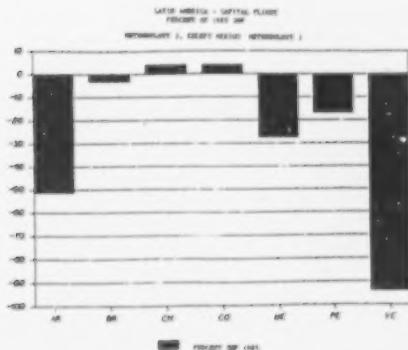
Certain portions of The Baker Plan need to be kept alive - at minimum. One critical point relates to the commitment of the United States to support World Bank's MIGA - or Multilateral Investment Guaranty Program. This program provides the necessary political risk programs against expropriation, war risk and inconvertibility - which is becoming more important in the Third World.

We have discussed with The World Bank the growing importance which private leasing companies are playing to support the development of Third World air transportation systems by renting new fuel-efficient aircraft. The World Bank MIGA Program providing political risk insurance against expropriation and inconvertibility would augment leases to Third World airlines greatly.

Stemming the Flight of Capital

It is the encouragement of private investment inflow back into the Third World which is critical - and The World Bank's MIGA Program - which requires an initial subscription of only \$44 million by the United States is one very "fast-track" methods to encourage private capital inflow to the Third World. This program - which would be available for all private investors located worldwide - would do much to stabilize - and to reverse - the incredible phenomena of "flight-of-capital" from the Third World.

The levels of capital flight have been staggering (Conesa, "Cause of Capital Flight From Latin America"):



Senator SARBANES. Thank you, sir. I have to say to the panel, we're going to have to recess for a few minutes because there's a vote on and I will have to go and vote. I will return immediately and we can resume the rest of the testimony. Is there anyone else with a seriously pressing time problem, a plane to catch in the next ½-hour or something?

[No response.]

Senator SARBANES. We will be back in 10 minutes. We stand in recess.

[Recess.]

Senator SARBANES. I think we will resume.

Mr. Pierce, I know you have to go. If you have to go right now, go ahead whenever you feel it is necessary.

Mr. PIERCE. Thank you.

Senator SARBANES. We appreciate your testimony very much, and the thrust of it is—I am very frank to tell you I think the debt problem is being managed in a way that has been extremely harmful to our producers, and there's got to be a better way to handle this situation, which addresses both the problems of the financial institutions and the problems of our producers and the problems of the developing countries, in terms of getting them on a growth pattern, and I think you all have obviously borne the impact.

There is a new notion now to crowding out. In terms of being crowded out, you are being crowded out, in effect, is what is happening, but we appreciate very much, and we appreciate your patience.

Gentlemen, that vote, as I gather you sensed, got delayed and held on. The President's veto was sustained for the moment. It is now being reconsidered, on a vote of 66 to 34, and then Senator Byrd voted no, so he could then move to reconsider it, since you have to be on the prevailing side, which he then did. So now there is a motion to reconsider it. For the moment, at least, it's been sustained.

Mr. Andreas, why don't we take you next.

STATEMENT OF DWAYNE ANDREAS, CHIEF EXECUTIVE OFFICER, DANIELS MIDLAND CORP.

Mr. ANDREAS. All right, Mr. Chairman. Thank you very much for inviting me.

My observations will be about agricultural trade and are supported by what I learned presiding as Chairman of the President's Task Force on International Private Enterprise.

The focus of that task force was on the private sector and, in particular, trade and investment in developing countries, and it went considerably beyond just agricultural trade, with which I am most familiar.

Both personal experience and the findings of the task force lead me to these conclusions.

Agricultural trade practices of the past must share heavily in the responsibility for creating much of the Third World debt problem. Better agricultural trade practices in the future could contribute considerably to the easing of the Third World debt problem.

SOME CAUSES OF THIRD WORLD DEBT PROBLEM

Let's look at how predatory world agricultural practices have helped cause the massive debt problems of the Third World countries. Just raising the question turns the spotlight immediately on the damage done to the Third World economies by the dumping of sugar and other agricultural products in such a way as to drastically impair and depress the incomes of the developing countries.

Sugar is a particularly good example, because, historically, so many of the Third World countries have depended upon sugar for their export earnings. The dumping of sugar by the EEC has depressed world sugar price to such an extent as to deprive the Third World of more than \$6 billion annually of dollar income. That is according to a study by the respected Economic Perspective Group in McLean, VA. Mr. Chairman, I am submitting a copy of that recent study for the record, in support of my statement.

[The information referred to may be found on p. 588.]

It has been such drastic cuts in income from exports, at a time of higher costs for fuel imports, that have caused the developing countries to borrow so heavily.

We were more directly involved in another factor contributing to excess borrowings.

During this same period of lost export earning by developing countries the United States was reducing its foreign aid and reducing concessional financing of its own exports to Third World countries. The added dollar drain to meet export requirements lessened their ability to service their growing debt.

It is obvious that the Third World debt crisis has meant a lot to our agricultural trade. Over the past 6 years, U.S. agricultural exports to the developing countries has declined by \$6.2 billion from \$16.9 billion in 1981 to only \$10.7 billion in 1986, according to USDA's outlook, table 18.

The cumulative total reduction during that period amounted to \$18 billion during that period which, as a coincidence, happens to approximate the surpluses that we own at the present time.

What can we do right now to alleviate the problem they have in servicing their debt?

As far as agricultural trade is concerned, we could at least make it possible for them to import more of their food requirements without laying out hard dollars. We could double or triple the use of Public Law 480 or other concessional food aid authorities at little out-of-pocket cost to ourselves, and yet at substantial hard currency savings to the Third World countries. This would enable them to conserve and utilize their hard currency to better service their existing debt rather than adding to it.

In view of credit restraints, heavy debt and interest burdens, many developing countries are reducing food imports for consumption far below nutritional needs. The Department of Agriculture has ample authority under Public Law 480, Food for Peace, and Section 416 of the Farm bill to sharply increase food aid, and in fact, has a mandate in Congress to do much more than it is now doing.

We could also greatly expand our use of mixed credits to make it possible for Third World countries to finance other import require-

ments without spending so much hard currency, again, conserving hard currency to service that debt.

Treasury and Eximbank have agreed to a token amount of \$200 million of mixed credits for a mixed credit program; however, I want to point out that our task force studied this matter thoroughly and found that \$10 billion to \$11 billion of mixed credits annually are needed to match our competitors and thus regain our competitive posture in world trade.

Both of these world trade actions could be helpful in the current debt emergency, but neither is adequate without doing something about the predatory practices now destroying income of Third World countries.

EEC DUMPS SUGAR ON WORLD MARKETS

The EEC continues to dump sugar on world markets. Its high internal production price structure, at great internal expense, stimulates unneeded production, discourages domestic consumption. And to avoid continued buildup of surpluses, results in an export subsidy system that destabilized the world prices. The EEC's share of the fragile world market has risen from 0 in 1975 to over 25 percent. Secretary Lyng recognized the effect of these predatory practices on the developing countries, when he said, on September 5, in reference to the EEC sugar policy, and I quote:

The less developed countries bear the brunt of this policy. Dumping sugar has depressed prices of the stocks which they must sell. This has resulted in billions of dollars of losses in export earnings.

It is not adequate to criticize such a policy as inefficient,

Secretary Lyng continued,

It should be plain to see that this sort of predatory action against some of the world's weakest economies is downright immoral.

Now that is our Secretary of Agriculture's very frank and blunt appraisal of this situation. But what is anybody doing about it?

On June 28, 1982, President Reagan, in an official Federal Register determination concluded, and I quote:

I have determined that the appropriate action to take at this time in response to EEC subsidies on sugar exports is to direct the USTR to continue its deliberations with the EEC and to support and work with other countries on the GATT and ISO with the aim of bringing about an end to such practices.

We could call even now for an emergency conference to negotiate with the EEC to induce them to stop their outrageous dumping of sugar, which is impoverishing the Third World and forcing sugar prices to disastrous price levels below anyone's cost of production. After all, the Third World's debt is not our problem alone. It is particularly their problem.

The withdrawal of unneeded EEC sugar from the world market could make it possible for the United States to adjust its own sugar policy and the Third World countries to enhance their export earnings by many billions of dollars by simply bringing the price of sugar back to the normal cost plus a reasonable profit.

There are limits, however, to what we alone can do.

The United States can ill-afford to throw good money after bad by lending more and more to those who already owe too much. And the United States cannot afford to simply absorb unlimited imports

Action - Not Further Debate

The Third World Debt Crisis is of much longer duration than anticipated in 1982.

Many stop-gap programs were proposed - and some were implemented

A more permanent program needs to be put in place now. The recent moratorium declared by Brazil should make it clear that the debt-service burden is becoming intolerable. In fact, our international economic security is jeopardized.

A host of proposals have been advanced which offer more "permanency" - or stability - for the Third World nations. Such programs recognize the Debt Crisis is here to stay for a long time.

The Japanese Program

It is interesting to note that the Japanese have taken an initiative recently in setting up a Cayman Island facility to act as the general collector for certain high-risk sovereign debt. According to Business International - it would operate essentially as a factoring company and buy the debt from the banks at a discount. Such action may place Japanese banks and companies in a stronger competitive position - and provides new impetus to the secondary debt market.

The Japanese know how to "work a problem" effectively - we might learn from them. In fact, our experience has been that the Japanese banking community is one of the most aggressive and supportive sectors of export financing of U.S. - I repeat - U.S. (produced) aircraft - and that spells job - and (U.S.) exports.

While others talk - they act. There's got to be a lesson here.

Thank you, Mr. Chairman.

Statement of

J. B. L. Pierce
Treasurer—The Boeing Company

U.S. House of Representatives
Committee on Banking, Finance and Urban Affairs
Subcommittee on International Development
Institutions and Finance

160

"Developing Countries' Debt and U.S. Trade"
March 19, 1986

BOEING

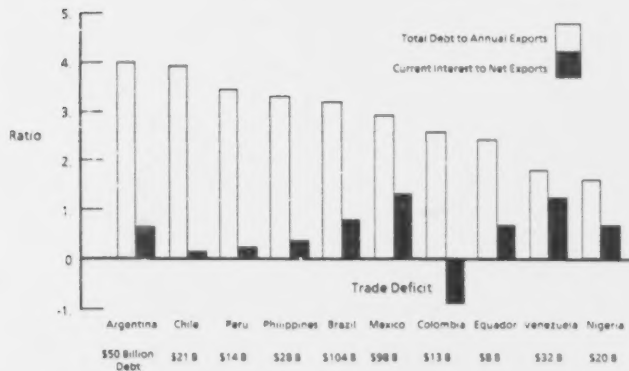
Thank you, Mr. Chairman. My name is Jack Pierce and I am Treasurer of The Boeing Company. I appreciate this opportunity to testify before your committee.

The Boeing Commercial Airplane Company is heavily dependent upon foreign markets for sales. Over the last 10 years, over 60% of our deliveries have been to non-U.S. airlines. Boeing is one of this nation's top five exporters. The Third World countries, until the 1982 Debt Crisis, was one of our fastest growing markets. However, today, some of these countries are so indebted that their export earning power won't even cover their existing debt service costs.

balance that suffers. As import restrictions are imposed, distortions begin to emerge which impede the normal flow of trade, such as export financing among exporter nations. The evolution of subsidized Mixed Credits and Tied-Aid financing are good examples. In certain cases, we have been able to preserve some business in the Third World by permitting the airlines to use - or rent - aircraft through operating leases. But leasing can be costly, and has little real impact on trade balance problems.

Tools like Countertrade in the form of barter... or offset agreements... are necessary. Some have promoted barter as one solution. In

MFigure 1
Major LDC Trade and Debt
1984

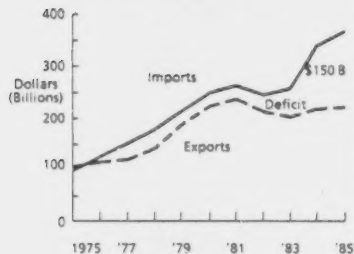


When Third World nations face adjustment programs which dictate restrictions on imports... and expansion of exports... as the TOP domestic priority, it is the U.S. trade

truth, the track record of bartering is less than impressive. Barter is inefficient. Most is executed using "near cash" type goods... like oil and other commodities, which now, due to

falling commodity prices, are creating substantial difficulty for bartering parties. Success stories have gained attention, e.g., Saudi oil for aircraft, Algerian oil for Japanese autos...Jamaican bauxite for trucks and cars and Ghanaian diamonds, wood and rubber trades to Bulgaria for pharmaceuticals and agricultural equipment. But, there are only a limited number of success stories here.

Figure 2
History of U.S. Trade Trends
Merchandise Trade in Billions



The grim fact remains...the poor nations of the world are becoming even poorer...less capable of repaying outstanding external debts. The precipitous drop in commodity prices has caused substantial loss of potential foreign exchange earnings. Also, economic growth in the industrialized nations of the world has been too slow to pull the Third World out of its debt predicament.

During the 1982 debt crisis, it was estimated that a minimum "real" growth rate of 3% in the O.E.C.D. nations was necessary to permit the Third World to overcome its debt...over a period of years...and assuming trade channels would remain open. However, such growth has not occurred since 1982 in the O.E.C.D. countries. "Rolling over" old debt or re-scheduling has prevailed.

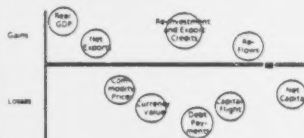
Table 1
Economic Growth in Industrialized Countries
(Percent Change in Real GNP)

Country	1960-69	1970-79	1980-85	1986
				Forecast
U.S.	4.2	3.1	2.1	2.8
Japan	11.6	5.4	4.3	3.4
Germany	5.6	3.1	1.2	3.2
France	5.8	4.1	1.2	2.0
U.K.	3.1	2.4	1.1	2.5
Italy	6.3	3.3	1.4	2.0
Canada	5.2	4.2	1.9	3.0
Seven Countries	5.7	3.6	2.2	2.9

Source: Morgan Guaranty, December 1985

There will be more trade disputes...and continued credit wars...if O.E.C.D. economic growth remains at or below 3% per year. Asian and Middle East (OPEC) markets now exhibit slower growth. The Third World, in order to repay its debt, must have export markets for its products...open and capable of buying its products.

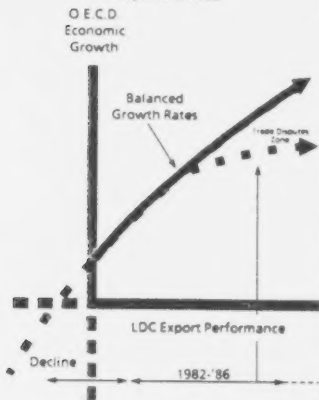
Figure 3
LDC Debt Growth Continues



Some easing of trade protectionism in the U.S. may only be a temporary phenomena, based on expectations that a lower dollar will relieve some friction between the U.S. and its trading partners. But, other O.E.C.D. nations have become even more export dependent these past few years, building an industrial base oriented toward world markets, mostly the

U.S. The number of complaints and investigations by the I.T.C. last year set a new record. More high tech industries are seeking relief.

Figure 4
Output and Trade



The Third World debt crisis should be viewed as a U.S. international security problem, not just an economic or financial one. If these nations cannot regain normal trading and economic growth, perhaps by limiting the amount of foreign exchange devoted to debt-servicing, then the debt crisis will become more politicized. The Cartagena Group has become more vocal and candid in proposing interest rate relief. They advocate a cap on the percent of their annual foreign exchange to be devoted to repayments. Some have suggested outright moratorium. They are becoming less willing to accept the political and economic cost of further IMF-like Adjustment programs.

A more permanent and stable solution is needed. Secretary Baker's Plan has been proposed as a remedy. This Plan needs to be gauged carefully, with regard to expectations. Is there enough funding suggested to do the job adequately? While much sound rationale has gone into the Baker Plan vis-a-vis the Long Term, will it produce some debt relief immediately? What other kinds of economic shocks that are inevitable will the plan accommodate?

Figure 5
Growth in O.E.C.D. Imports From LDCs

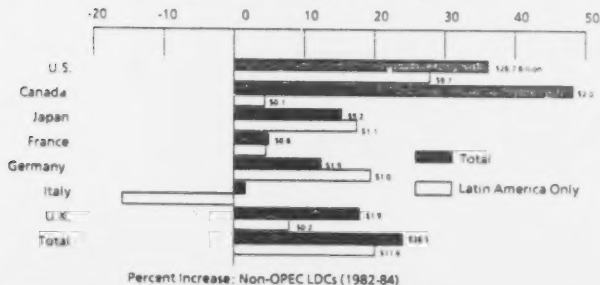
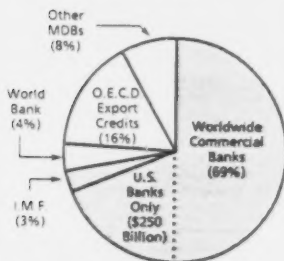
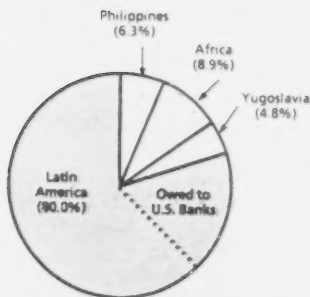


Figure 6
Owners of \$920 Billion Third World Debt
(Year End 1985)



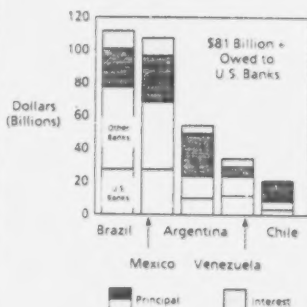
The enormity of the problem is concentrated in the Latin American nations. Ten of the 15 nations included in the Baker Plan lie south of our border. Of the \$437 billion Baker 15 debt, \$350 billion is Latin American indebtedness, and of that, 87% is owed by only five.

Figure 7
Baker's Top 15 Indebted Nations
(1985 Principal Only)



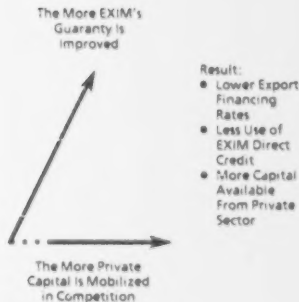
Some Congressional support must be forthcoming. Congress must face the near term capital increase requirements of The World Bank. The potential leverage is impressive: 60 to 1. The Multilateral Investment Guarantee Agency proposed in Mr. Lundine's legislation is an incentive necessary to encourage a return of private capital flows in both debt and equity participation. Raising the "gearing ratio" of The World Bank to 2 to 1 deserves in-depth examination.

Figure 8
Top Five Latin Debtors: 87% of \$350 Billion
(1985 Principal - 1986 Interest Due)



You have requested our views on how the Third World debt crisis may affect U.S. trade interests... and the jobs dependent on these markets. America's commercial jetliner industry will see the non-U.S. market continue to dominate our marketing efforts. The LDC nations represent a substantial market. I would like to address some ways in which Congress can assist all U.S. exporters, especially the capital goods sector which, for the first time in decades, face a trade deficit in 1985.

Figure 9
Enhanced Eximbank Guaranty



First, exporters are seeking an Enhanced Financial Guaranty from the Eximbank. We believe it will be a very innovative and effective means to draw more sources of private capital into the export financing arena, lower the costs to buyers and exporters, eliminate the need for subsidies, contribute to reducing the Federal Budget and address some of the Third World capital goods requirements.

EXIM Direct Credit Program

It is also imperative that the Eximbank Direct Credit program continue to support U.S. exporters selling to Third World nations.

Although the EXIM Guaranty represents the full faith and credit of the U.S. Government, banks will not provide a loan supported by such a guaranty if the expectation is likely that the guaranty will be called upon. Furthermore, banks are reluctant to rely upon the EXIM guaranty if they expect the nation in question will undergo re-scheduling downstream. Country limits inhibit the banks' participation as well, even with a guaranty. It is for this reason... special debtor country situations... that the Direct Credit program at Eximbank continue. Unless there is a special program to assist U.S. exporters with direct credits to foreign buyers in Third World countries, it is likely that we will lose exports, and jobs related to these markets... and to foreign competition, who are willing to provide the needed credits.

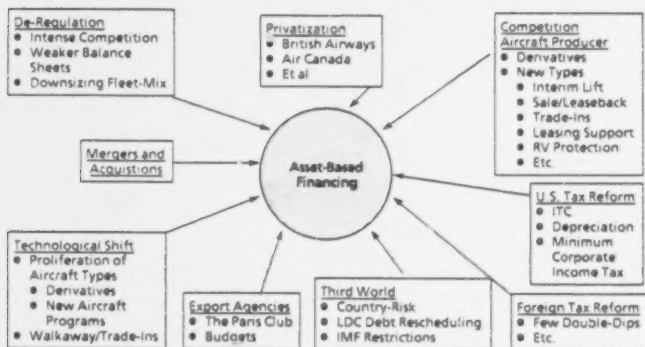
New Techniques of Export Financing Using Asset-Based Financing

For certain products, which can be leased, (aircraft, for example) new programs are emerging which use the asset value of the product as a basis for export financing. The primary security to support the financing is the very product itself. In these cases, the aircraft is leased to the airline, with the expressed understanding that title does not pass. In essence, the aircraft is rented.

Exim has been helpful in developing new leasing programs to support these kinds of transactions. EXIM has developed a new political-risk insurance program which protects against "confiscation," so that even in cases of default, the aircraft can be repossessed and EXIM will cover the major portion of the non-repossession risks.

These transactions - asset-based - permit aircraft, for example, to be exported into Third World nations to be used by the airlines in the form of a lease or rental agreement. By avoiding purchase, no debt is incurred... on

Figure 10
Asset-Based Financing



either the airline or the country's balance sheet. Thus, the LDC, even with restrictions imposed by their Ministry of Finance, can have what they need... and avoid adding to their debt or re-scheduling problems.

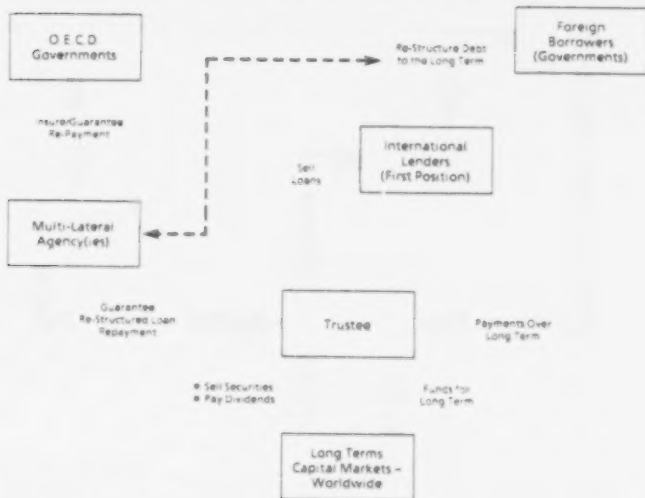
...Securitization

The ability and opportunity to securitize outstanding Third World debt, and reduce the prevailing interest costs, while recasting these debts into longer maturities... is worth our focus. It is clear that much of the debt is being kept "on the books" at face value, yet if securitized, with longer maturities, some discount features would be necessary. But it would be one way to remove from the Third World the constant necessity to renegotiate short term debt. What is the real difference between openly recognizing the fact that such LDC debt cannot be immediately repaid at full face value... and converting it into more manageable repayment periods... rather than continue to charade of "rolling over" debt, constantly jolting the Ministries of Finance in these LDCs?

Stability is most important... then follows more efficient planning and normal trade relations. A joint program developed around securitization concept between the commercial banking industry and international agencies, such as the World Bank, could give the LDCs some "breathing" room, and rebuild the reserves of the banks.

It is interesting to note that Morgan Guaranty's February 8th newsletter acknowledged that the 1981-85 debt management strategy took the classical approach... seeking to strengthen export performance of LDCs and curtailing imports. The article noted that previous experience with the classical prescription in Europe and in some Latin American countries suggested that trade performance should be sufficiently improved after two or three years to restore normal credit flows, promote repatriation of flow-away capital and allow resumption of sound economic policy. However, the last three years proved this approach to be less than adequately responsive to the changing needs... nothing more than a "stop-gap" one.

Figure 11
Securitization Concept for Third World Nations



In short, the classical approach is not working. Something of a more permanent nature is necessary.

In summary, Mr. Chairman, I endorse your proposals which call for accelerating the disbursement of the World Bank's capital, increases in structural adjustment and industry sector oriented lending, plus the MIGA and the increased "gearing" ratio of up to 2 to 1. I won't comment on changes in banking regulatory guidelines. This is just not my forte. I would encourage you to pursue attempts to securitize country debts, creating some mutually funded agency to act as trustee

and oversee the flow-through of cash and guarantees required.

Before I conclude my testimony, I would offer one further idea. Trade distortions, due to export financing competition among government credit agencies have diminished in recent years, thanks to efforts of the Eximbank and the Treasury Department. However, there is a need today to begin addressing a rising source of friction and frustration; otherwise the playing fields of international competition will again be tilted against U.S. interests.

A Master Guarantor program at the World Bank, or an affiliate, is needed to insure equality of opportunity for all participants in the growing internationalization of "big ticket" capital goods production, large-scale construction, engineering and power generating projects. More and more, these kinds of projects contain multi-national "shared-production" content. No single national credit agency will, or should, provide all the financial support necessary; but inevitably, they will compete over financing their national portions of the export. The U.S. should take the initiative to head-off this activity before it gets worse.

For example, in competition between U.S. and Airbus producers, various components of each aircraft are produced in different countries. Airbus produces its jetliners from parts made in France, Germany, England, Spain and the United States. Our 767 is produced in the U.S., Canada, Italy and Japan. It would equalize competitive pressures if all of the export credit agencies of these countries extended only pure cover... their guaranty... and the private capital markets could provide the export financing funds. However, today each country's guaranty is not treated equally in the world's capital markets. For example, an EXIM guaranty in the United States is better received than a COFACE... or HERME... or ECGD guaranty. Certain capital sources, such as insurance companies and pension funds, cannot provide funding using a foreign agency guaranty, beyond a total of 1% of its total portfolio. This portfolio-based rule excludes Airbus from U.S. capital markets, and they can be quite imaginative in finding alternates.

The answer to this potentially troublesome trade activity is for the various export credit agencies to extend their guaranty to the World Bank, which would then provide its guaranty, "pure cover"... to all participants equally. This "umbrella" guaranty, or service as a Master Guarantor, would bring more private capital to the market, lower costs/rates and greater trade among all nations.

Thank you, Mr. Chairman.

to service the debts when we already have an emergency trade balance deficit of our own.

But we certainly can afford to finance some of the Third World imports of agricultural commodities which we have in huge surplus and which are costing us more in storage and deterioration and the cost of shipping them abroad. And we certainly can afford liberal concession credits, mixed credits, to export our incremental production of manufactured goods, which, if not exported, simply leaves us with idle people and idle plants. If the United States could come up with enough credit for Public Law 480 and Export-Import Bank credits to make meaningful transfusion of goods to these countries, their ability to service their debt would be greatly enhanced.

These are short-term answers and perhaps they are all we can do right now, but sooner rather than later, for our own sake, for the entire world's sake, as well as the sake of the Third World countries, we must come to grips with the vast current distortions in agricultural world trade.

We have elevated the economic theory of "free trade" to a status of a national theology and follow its simple dictums as if they were immutable law. We seem prepared to follow its precepts even if it means plunging into an economic abyss. We have, in short, sacrificed our economic strength on the altar of "free trade."

FREE MARKETS

We espouse a free market system and expect others to operate under that system. It is one in which the laws of comparative advantage ply and where conduct is determined by a common framework of rules, regulations, laws, and customs, but such a system only works when everyone plays by the same rule. In reality, most of the nations do not want to play by our free market rules, and we have been unable to convince or force them to do so.

These are the nations who place their self-interest first. They favor unequal competition because their highest priority is not equality of trade but to maximize the production of goods and capture the maximum amount of benefits which accrue from activity—jobs, gross output, and tax revenues.

Maximizing output involves capturing market demand and even though at the expense of other nations. This involves government/private entity collaboration to gain access to markets abroad, self-serving nations employ treasury subsidies, processing and manufacturing credits, favorable banking practices, local content requirements and exchange rate controls. Domestic markets are protected from foreign competition by tariffs, quotas, and internal regulatory mechanism. Comparative advantage to gain market share is, therefore, not a function of competitive price, but a function of product price plus direct and indirect treasury subsidies. The effect of these practices is to tilt the playing field in favor of the self-serving.

There is no place in the free market equation to balance predatory actions of government. Nations who continue to pursue a free market illusion will be exploited.

If there is to be a reversal of this decline, policymakers must cast aside this free market illusion and accept the realities of a global

marketplace and develop mechanisms which insure access to a global market for American production.

In the United States, our Government is the only domestic institution which is capable of effectively dealing with the accelerating tendency of socialist mercantile states to compete globally with private enterprise by employing all of these import restraints and export subsidies.

Now the United States could set an example on a longer range project for all the world to see. After the Canada-United States free trade agreement is signed, we could consider inviting Mexico to join with Canada and the United States in a North American free market system, free market area. My impression is that such a proposal would meet the enthusiastic approval of the Canadians. It is my belief that the creation of such a free market area would lead to hundreds of billions of dollars of new investments in Mexico, in order to utilize the extraordinary pool of high quality labor that will be available there as soon as the poor are well fed.

It would be a way of becoming instantly competitive with Japan, Taiwan, and South Korea, giving the United States and Canadian industry a huge leap forward. Such a surge in activity would make North America the most important market in the world, competitive with the EEC and Japan. Other countries would be willing to make major concessions just for access to such a market. Such an economic merger of Canada, the United States, and Mexico would create a foundation for 50 years of prosperity in this part of the world.

I urge you, Mr. Chairman, to make a study and analysis of this suggestion. Our President, along with this Congress, could make a major mark in history, by bringing North America together as a free trade zone. Who knows, the Caribbean and South America might ultimately be pleased to join.

Now Mr. Chairman, I ask your permission—after I had written this material, I picked up yesterday's Chicago Tribune, and I found an article in there by Dean Etchison, which is an excellent explanation. He is the director of the Illinois Department of Energy and Natural Resources, and a lecturer at Sangamon State University, and it is an excellent article on the merits of forming a free trade area with Mexico, and I would like to put it, along with mine, in the record, if you would permit me to do so.

Senator SARBANES. It will be so included.

[Complete statement of Mr. Andreas and newspaper article follow:]

Testimony by
Dwayne O. Andreas
before
The Subcommittee on International and
Monetary Policy of the Senate Banking Committee
April 1, 1987

Mr. Chairman, thank you for inviting me to appear before this important body to comment on the relationship between agricultural trade and Third World debt.

My observations and conclusions are personal based upon 40 years of experience dealing with world agricultural trade.

They are strongly supported, however, by what I learned as Chairman of The President's Task Force on International Private Enterprise. The focus of that Task Force was on the private sector, and, in particular, trade and investment in developing countries. It went considerably beyond just agricultural trade with which I am most familiar.

Both personal experience and findings of that Task Force lead me to these conclusions:

...Agricultural trade practices of the past must share heavily in the responsibility for creating much of the Third World debt problem; and,

.....Better agricultural trade practices in the future could contribute considerably to easing the Third World debt problem.

Let's look at how predatory world agricultural trade practices have helped cause the massive debt problems of Third World countries. Just raising the question turns the spotlight almost immediately on the damage done to Third World economies by the dumping of sugar and other products in such a way as to drastically impair and depress the income of developing countries. Sugar is a particularly good example, because historically so many Third World countries have depended upon it for their export earnings.

Dumping of EEC sugar has depressed world sugar price to such an extent as to deprive the Third World of more than \$6 billion annually of dollar income, according to a study by the respected Economic Perspective group in McLean, VA. Mr. Chairman, I am submitting a copy of that recent study for the record in support of my statement. It has been such drastic cuts in income from exports, at a time of higher costs for fuel oil imports, that have caused the developing countries to borrow so heavily.

We were more directly involved in another factor contributing to such excessive borrowings.

During this same period of lost export earnings by developing countries, the United States was reducing its foreign aid, and the concessional financing of its own exports to Third World countries. The added dollar drain to meet import requirements lessened their ability to service their growing debt.

It is obvious what the Third World debt crises has meant to our agricultural trade. Over the past six years, U.S. agricultural exports to developing countries has declined by \$6.2 billion -- from \$16.9 in 1981 to only \$10.7 in 1986, according to data in USDA's Outlook for Agricultural Exports (Table 18). The cumulative total reduction amounted to 18.1 billion dollars during that period, which happens to approximate the surpluses we now own.

What can we do right now to help alleviate the problem they have in servicing their debt?

As far as agricultural trade is concerned, we could at least make it possible for them to import more of their food requirements without laying out hard dollars. We could double or triple our use of Public Law 480, or other concessional food-aid authorities, at little out-of-pocket costs to ourselves, yet at substantial hard currency savings to Third World countries. This would enable them to conserve and utilize their hard currency to better service their existing debt, rather than adding to it.

In view of credit restraints, heavy debt, and interest burdens, many developing countries are reducing food imports for consumption below nutritional needs. The Department of Agriculture has ample authority under P.L. 480 (Food for Peace) and Section 416 of the Farm Bill to sharply increase food aid -- and, in fact, has a mandate from the Congress to do much more than it is now doing.

In view of our abundant supplies, and our well deserved image as a humanitarian nation, significant increases in such food assistance would be mutually beneficial:

...It could help Third World countries meet critical food needs at a time of a serious dollar shortage;

...It could signal the intention of the U.S. to come closer to eliminating hunger through official food aid; and

...It could provide significant benefits to our own depressed farm economy, at little real U.S. costs, while strengthening the long term ability of developing countries to meet their own needs.

We have the know-how to handle these additional supplies in such a manner as not to disrupt commercial markets or act as a disincentive to local production.

We could also greatly expand our use of mixed credits to make it possible for Third World countries to finance other import requirements without spending so much hard currency, again conserving that hard currency to service debt.

Treasury and Exim Bank have agreed to a token \$200 million mixed credits program. However, our Task Force found that from \$10 to \$11 billion in mixed credits annually are needed to match our competitors and thus regain our competitive posture in world trade.

Both of these World Trade actions could be helpful in the current debt emergency, but neither is adequate without doing something about the predatory practices now destroying income of Third World countries.

The ECC continues to "dump" sugar on world markets. It's high internal production price structure, at great internal expense, stimulates unneeded production, discourages domestic consumption, and, to avoid continued build up of surpluses, results in an export subsidy system that destabilizes world market prices. It's share of the fragile world market has risen from zero in 1975 to over 25%. Secretary of Agriculture Lyng recognized the effect of these predatory practices on developing countries when he said, on September 5, 1986 in reference to the EEC Sugar Policy:

"The less developed countries bear the brunt of this policy. Dumping sugar has depressed prices of the stocks which they must sell. This has resulted in billions of dollars of losses in export earnings."

"It is not adequate to criticize such a policy as inefficient," Secretary Lyng continued. "It should be plain to see that this sort of predatory action against some of the world's weakest economies is downright immoral."

Now, that is our Secretary of Agriculture's very frank and blunt appraisal of this situation. But what is anybody doing about it?

On June 28, 1982, President Reagan, in an official Federal Register Determination concluded, "I have determined that the appropriate action to take at this time in response to EEC subsidies on sugar exports

is to direct the USTR both to continue its deliberations with the EEC and to support and work with other countries on the GATT and ISO with the aim of bringing about an end to such practices."

We could call for an emergency conference to negotiate with the EEC to induce them to stop their outrageous program of dumping sugar, and forcing sugar prices to disastrous price levels in the world market below anyone's cost of production. After all, the Third World's debt problem is not our problem alone.

The withdrawal of unneeded EEC sugar from the world market could make it possible for the U.S. to adjust its sugar policy and the Third World countries to enhance their export earnings by many billions of dollars by simply bringing the price of sugar back to normal cost, plus reasonable profit level.

During the rest of this century, foreign policy will be dominated by economic considerations.

The effects of massive defaults by one or more of the developing country debtors is only one of the potential elements which threaten to uproot many of our basic foreign policy premises and cause acute problems ahead. Other include:

1. The rapidly deteriorating U.S. balance of trade, with no end or even a reasonable plan in sight; and
2. The already huge -- and still growing -- tendency of socialist mercantile states to compete with and weaken the private enterprise system.

You can hardly discuss one without considering the others. They are just too interlocking.

That is why the Task Force which I chaired strongly recommended establishing a National Economic Security Council in the White House to monitor international economic actions on a day-to-day, week-by-week basis, and thereby better coordinate our own economic responses so we should remain competitive.

We simply must recognize the full economic effects on the rest of the world of a cumulative trillion dollar balance of payments deficit over the next ten years -- and do something about it.

We must use GATT negotiations and other means to rid the rest of the world of existing predatory practices -- not only for the sake of the developing countries, but our own sake as well.

Without the leverage of aggressive mixed credits and PL 480 programs, we have an extremely difficult negotiating position at GATT.

There are limits to what we alone can do.

The United States can ill-afford to throw good money after bad by lending more and more to those who owe too much already.

And the United States cannot afford to simply absorb unlimited imports to service the debts when we already have an emergency trade balance deficit of our own.

But we certainly can afford to finance some of the Third World imports of agricultural commodities which we have in huge surplus -- and which are costing us more in storage and deterioration than the cost of shipping them abroad. And we certainly can afford liberal concessional credits -- mixed credits, to export our incremental production of manufactured goods which, if not exported, simply leaves us with idle people and idle plants.

If the United States could come up with enough credit for PL 480 and Export -- Import Bank to make a meaningful transfusion of goods to these countries, their ability to service their debt would be greatly enhanced.

These are the short term answers, and perhaps they are all we can do right now.

But sooner rather than later, for our own sake, and for the entire world's sake, as well as the sake of Third World countries, we must all come to grips with the vast current distortion in world agricultural trade.

Mr. Chairman, I will conclude my verbal remarks at this point, but ask your consent to have the remainder of my testimony made part of your hearing record. Some of it may go beyond the scope of your immediate hearing on Third World debt, but it is about a root cause of many of the economic problems in world agriculture -- for developed and developing countries alike.

We have elevated the economic theory of "free trade" to the status of a national theology, and follow its simple dictums as if they were immutable laws. We seem prepared to follow its precepts, even if it means plunging into an economic abyss. We have, in short, sacrificed our economic strength on the altar of "free trade".

We espouse a free market system and expect others to operate under that system. It is one in which the laws of comparative advantage apply, where conduct is determined by common framework of rules, regulations, laws and customs.

Such a system only works when everyone plays by the same rules.

In reality, most nations do not want to play by our "free market" rules and we have been unable to convince or force them to do so.

These nations place their "self-interest" first. They favor unequal competition because their highest priority is not equality of trade but to maximize the production of goods, and capture the maximum amount of benefits which accrue from such activity -- jobs, gross output, and tax revenues.

Maximizing output involves capturing market demand even though at the expense of other nations.

This involves government/private entity collaboration to gain access to markets abroad, self-serving nations employ treasury subsidies, processing and manufacturing credits, favorable banking practices,

local content requirements and exchange rate controls. Domestic markets are protected from foreign competition by tariff barriers, quotas, and internal regulatory mechanisms. Comparative advantage to gain market share is therefore not a function of competitive price, but a function of product price plus direct and indirect treasury subsidy or subsidies.

The effect of these predatory practices is to "tilt" the playing field in favor of the self-serving. They destroy the competitive balance which characterizes a free market system and makes it unworkable. They create an unequal exchange across borders in favor of the self-serving.

There is no place in the "free market" equation to balance the predatory actions of government. Nations who continue to pursue a "free market" illusion will be exploited.

We continue to pursue that illusion, and, as a result, we have seen our basic industries erode. That erosion generates decline in real economic activity. The symptoms of that decline are budget deficit of over \$200 billion, an external debt of over \$1 trillion, and trade deficit over \$140 billion.

If there is to be a reversal of this decline, policymakers must cast aside this "free market" illusion, accept the realities of global market place, and develop mechanisms which insure access to the global market for American production.

They must also understand that the strength of this economy lies in the output of goods and insure that those goods can reach market demand both at home and abroad.

They must understand, too, that what determines private sector behavior is the marketplace itself -- the most important part of which is shaped by government policy.

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The only way the private sector can fulfill its full potential is for government to create an environment that supports the growth of private sector activity and defends it from the incursion of policies which threaten it.

Our Government is the only domestic institution which is capable of effectively dealing with the accelerating tendency of socialist bureaucratic states to compete globally with private enterprise by employing import restraints and export subsidies.

The United States could set an example for all the world to see. After the Canada-U.S. free trade agreement is signed we could consider inviting Mexico to join with Canada and the United States in a North American free market area. My impression is that such a proposal would meet with enthusiastic approval of the Canadians. And it is my belief that the creation of such a free market area would lead to hundreds of billions of dollars of new investments in Mexico in order to utilize the extraordinary pool of high quality labor that will be available there as soon as the poor are well fed.

It would be a way of becoming instantly competitive with Japan, Taiwan and South Korea giving the United States and Canadian industry a huge leap forward. Such a surge in activity would make North America the most important market in the world, competition with the EEC and Japan. Other countries would be willing to make major concessions just for access to such a market. Such an economic merger of Canada, the United States and Mexico would create the foundation for fifty years of prosperity in this part of the world. I urge you to make a study and analysis of this suggestion. Our President, along with Congress, could make a major mark in history by bringing North America together as a free trade zone. And who knows, the Caribbean and South America might ultimately be pleased to join.

Pursuing a North American accord

By Don Etchison

In the first days of his presidency, Ronald Reagan spoke of a North American accord in which the United States and its continental neighbors would establish a new era of friendly cooperation. Unfortunately, little has been done to move us toward that goal, and the President is nearing the end of his second term without having restated this idea.

Yet there is no time like the present to explore international policies that make sense, whether nuclear arms treaties with the Soviet Union or better relations with one's neighbors. And as President Reagan prepares to meet with Canadian Prime Minister Brian Mulroney early in April, the time is right to lay the groundwork for greatly improved cooperation between the United States and its No. 1 friend and trading partner, Canada.

Although many outstanding issues between the countries need attention, two are central: acid rain and trade.

Last year the President agreed to the report of his special envoys that blamed the United States for much of the problem of acid rain in Canada and pledged a multibillion-dollar clean-coal program to remedy it. However, it was not until last week that the administration finally agreed to place in the budget \$500 million a year for five years for a clean-coal program. Given that the coming summit meeting was undoubtedly the catalyst for this timely announcement, the President now needs to show he can deliver the funds and implement an effective program.

The other issue that deserves center stage is free trade—or more correctly, freer trade—between the U.S. and Canada. A commitment by both leaders to this worthy goal is needed and desirable.

Bilateral discussions are underway between emissaries of the U.S. and Canada to relax trade barriers. In recent months, however, actions taken by both countries have shown regression, as each increased tariffs and duties on certain commodities and products.

The U.S. put a tariff on Canadian wood shakes and shingles in early 1986. Then the Canadians placed a countervailing duty on U.S. corn. Late last year, a threatened U.S. import duty on Canadian soft wood was avoided at the last minute after Canada agreed to raise its own prices. While this latter move helped bolster the U.S. forestry industry, it will mean higher prices for Americans buying new homes and it greatly upset many Canadians that they had been forced to raise their prices. In this context, U.S.-Canadian trade relations clearly need discussing at the top level. With both leaders' popularity sagging at home, some forthright diplomatic action would be welcomed.

While thinking about improving relations with our

well-developed neighbor to the north, it is equally important to consider our relationship with our immediate southern neighbor. It is difficult to think of a time since the Mexican Revolution of 1910-20 or the period of U.S. intervention in Nicaragua from 1909 to 1933 when there have been more tension and problems in Mexico and Central America. Decades of U.S. complacency over the stability of our southern neighbors have caused us—until very recently—to take them for granted. Instead of dedicating ourselves to really working toward an Alliance for Progress-type program of development and democratization for these countries, we have devoted more attention and money to far-flung places like Vietnam and the Middle East.

What goes around, comes around. We now find ourselves with a Marxist regime in Nicaragua and turmoil spreading in other Central American countries. On top of this is Mexico, which is in bad shape, having suffered from a deep drop in oil prices, a devastating earthquake, an enormous foreign debt and a high population growth. Millions of poor Mexicans live in abject poverty, with no hope for a better future. Mexico is a slumbering volcano ready to erupt; the only question is when.

If ever there was a time for the U.S. to pay attention to its southern neighbors and lend a helping hand, it is now. This would not, and should not, be an act of charity, but a step taken in our own self-interest. It is very much in the interest of the U.S. to have progressive and stable neighbors on the North American continent. Without the strong leadership of the U.S. in promoting trade, education and cultural exchange with our Hispanic neighbors, there is really little hope for their economic development, hence peace and stability. How many times must we learn the lessons of Cuba and Nicaragua?

Given this situation, the idea of a North American accord would be to open up trade, commerce, investment and educational opportunities among the nations of North America. The first step would be to focus attention on our two major neighbors, Canada and Mexico, and establish a high-level tripartite consultative body charged to work toward the idea of creating a North American accord.

Think of the possibilities: Canada and Mexico have great quantities of oil, gas and other natural resources the U.S. needs. The U.S. has large markets that both Canada and Mexico need access to. The U.S. and Canada have high technology and excellent educational facilities that Mexico must have to develop. Furthermore, Mexico has unskilled laborers willing to do jobs neither Canadians nor U.S. citizens will do. With so many U.S. manufacturing jobs having gone to Asia because of cheap labor, perhaps some could come back to North America if Mexican labor could be applied.

There are many positive elements in this mix that could produce significant benefits to the citizens of Mexico, Canada and the United States. The idea of a North American accord is one whose time has come. President Reagan has the opportunity to help establish this vision in his coming meeting with Prime Minister Mulroney. Let's hope he does not miss it.

Don Etchison, director of the Illinois Department of Energy and Natural Resources, also is a lecturer on international affairs at Sangamon State University and author of "The United States and Militarism in Central America" (Praeger, 1975).

Senator SARBANES. Thank you very much for your testimony. Bishop Weigand. We will include the entire testimony in the record as submitted, Bishop, and if you would care to summarize the high points, we would appreciate that very much.

STATEMENT OF BISHOP WILLIAM WEIGAND, BISHOP OF SALT LAKE CITY, UT

Bishop WEIGAND. Thank you very much, Mr. Chairman. On behalf of the U.S. Catholic bishops, I will make some remarks, especially from an ethical point of view, on the debt of the Third World countries. I am pleased to be accompanied today by Dr. Martin McLaughlin and Rev. Thomas Lewers, also from the U.S. Catholic Conference.

I am sure that you are aware that last November the U.S. Catholic bishops overwhelmingly approved a major pastoral letter, "Economic Justice for All." I had the privilege of participating in the bishops' committee which spent several years preparing the draft of that document. I was chosen, in part, because I had rather recently returned from nearly 10 years as a missionary among the very poor in Latin America.

Our Catholic tradition recognizes the crucial contribution of empirical analysis and technical competence to reaching fair and effective decisions on complex policy issues like the debt problem. We believe, however, that this expertise must be complemented by a moral perspective that takes cognizance of real people and the human problems behind the economic indicators.

THREE ISSUES OF PASTORAL LETTER

The argument of our pastoral letter rests on three premises.

First, the dignity of the human person created in the image of God is the measure against which every economic decision, policy, and institution ought to be judged.

Second, because this human dignity can be realized only in community, every person has a right to participate in the economic life of society.

Third, all members of the society have a special obligation to the poor and the disadvantaged. For us, the ultimate test of justice is how the economic policy choice affects the poor.

While we acknowledge that our three perspectives do not lead directly to specific policy recommendations, we nevertheless insist that purely empirical economic analysis should not lead directly to policy choices either.

The new debt burden of the Third World in 1986 alone resulted in a net transfer of nearly \$30 million to the industrialized countries, especially the United States. In our view, transfers of such magnitude are a scandal, coming as they do, from countries in which 800 million people live in poverty so miserable that it is beneath any rational definition of human decency, in which hundreds of millions of people are chronically hungry, in which 40,000 children die every day from malnutrition and disease, in which two-thirds of the world's people live at an economic level that constantly falls further and further below that of the industrialized world.

I have personally seen the faces of these people, touched their lives and had my own life ennobled by these talented people whose every day is one of survival.

A moral perspective would insist that significant sacrifices be made also by those who benefit materially from the debt situation. Better-off countries should handle a greater part of the responsibility.

In our written statement, we have included a historical summary of how the aggregate debt of the Third World developed and have also put forth some views about the systemic basis of this debt problem. I will not repeat here, except to say that what has happened in the 1980's, like what happened in the decade before, resulted not only from policy but from structure.

When in 1982, Mexico indicated its inability to service its debt and when other major debtors also got into difficulty, the commercial banks ceased lending and later rescheduled at higher interest rates and for large fees, but the International Monetary Fund's formula for meeting short-term liquidity problems, did not change. Their austerity measures fell heavy, indeed, upon the already desperately poor of the Third World.

In practice, it means, a lower living standard, increased malnutrition and poverty, higher unemployment, rising infant mortality and general damage to vulnerable groups in the debtor countries.

It seems to us that the injustice in these circumstances is rather clear. First, poor people in poor countries who bear the major burden of the debt crisis have little, if any, responsibility for contracting it, and yet must pay back debts pushed on their not un-eager but typically unrepresentative governments by banks in the industrialized world.

Second, poor countries, which shored up the industrialized world after the first oil shock by helping them avoid the full impact of the sharp increases in oil prices, but could not do so after the second, are now required to continue and, in fact, increase the net transfer of resources to the relatively rich north. To penalize these people and forget their contribution to us is not a ~~little~~ ungrateful.

Finally, the bulk of this debt is interest, not principal. Some persons of the Third World countries have wondered whether the front-loading of interest in these circumstances could be considered as usury. In a recent statement, Cardinal Arnes of Sao Paulo, Brazil, suggested that Brazil pay only the principal.

The Third World debt problem, up to now, has been handled solely as a macroeconomic problem and has generally ignored the question of justice altogether. The result has been that in order to sustain bank profitability, not just the soundness of the financial system, the IMF and its collaborators have insisted that foreign creditors of these debtor countries be paid in full and on time and at the great human costs that I have already referred to.

We are pleased with the growing tendency of late to recognize that the creditors must accept a share in the sacrifices needed to resolve the Third World debt crisis. It is worth noting, too, that the Latin American debt is owed mainly to commercial banks, but the debt of sub-Saharan Africa is owed mainly to governments and to the multilateral institutions created by governments.

As we pointed out in our pastoral letter, although their aggregate debt of about \$100 billion is only a quarter of that of Latin America, their collateral is much less adequate. Their ability to service their external debt is much weaker, and the possibility of their rescheduling is very small. In this case, we believe that forgiveness, perhaps in the guise of converting this official debt to a local currency obligation to be paid into a development bank in the country might be an appropriate and effective solution. Criteria for such conversion would, of course, have to be carefully worked out.

VATICAN PUBLICATION

There is a recent publication of interest on this topic from the Vatican's Pontifical Commission, *Justitia et Pax*, entitled "At the Service of the Human Community: An Ethical Approach to the International Debt Question." It is cited extensively in our written statement. The first ethical principle it enunciates is coresponsibility. But the Vatican document and our own pastoral letter point out that the fact of interdependence must have its counterpart in a solidarity that respects the equal dignity of all peoples and accepts joint responsibility for the causes of the debt of the developing countries and for a solution to the problem.

The Vatican document also expressed a concern which we strongly share, namely, the fledgling democracies, especially in Latin America, in order to carry out austerity programs may feel it necessary to adopt increasingly unpopular policies that could bring back the same kind of authoritarianism that led to the debt crisis.

These democracies, we feel, are, indeed, threatened. We should not underestimate this danger. I recall from my own years of service among the very poor in Colombia, before the debt problem, that when the government tried to reduce the subsidies to a mass transit program, which for the very poor was their only transportation, even in those days, in the early 1970's, severe riots and public and civil unrest would result. I, myself, was found more than once in the midst of riots at the fear of my life with my car being stoned, and so forth, because of the anguish of people stretched to the limit, even then. And the situation is now worse.

We ought also to understand what happens when the huge capital outflow from these poor countries inhibits their maintenance of a minimal level of essential services for the people and, in many cases, causes a decrease in the already very low standard of living.

When I first went to Cali, Colombia, part of the very poor area that I worked in, had no electricity, no sewer systems, no bus service etc—many of the very simple dwellings yet had a dirt floor. In 10 years, at the end of my stay, that area of the city had gone through lots of phases of development, where people had those services and the government had been doing a credible job in trying to raise the standard of living of those people. To see now that governments are unable to do that, is shocking and disappoints me very much.

I would like to conclude—I see the red light is on—by acknowledging again that moral principles do not lead to concrete solutions very directly, and so we do not suggest concrete solutions, although, Mr. Chairman, we are impressed the possibilities latent in

your own plan. I would like to suggest, however, that the principles do suggest guidelines for assessing those proposals. And let me just end by briefly stating a few.

One, responsibility for the solution must be shared with debtor countries in an equitable fashion by both public and private creditors. This is the principle of coresponsibility.

Two, the primary objective of any approach must be to lift the debt burden from the poor and to improve the quality of their life to restore an equitable share in economic growth.

Three, criteria for adjustment of each country's debt situation should take into account what the money was borrowed for, how it was used and how the debtor nation proposes to stop capital flight and root out corruption.

Four, any structural adjustment or other debt solution package must preserve the basic human rights of the citizens of the debtor country and the integrity of its government.

Five, any viable solution must also recognize and relieve external factors beyond the control of the debtor country that tend to aggravate and perpetuate the burden—interest rates, commodity prices, trade barriers, budget deficits and the like.

Six, some immediate benefit should accrue to the debtor country itself and especially to the poor, the masses of the population of those debtor countries.

Finally, we need to look very deeply into the entire system of international finance, as we try to solve these immediate problems. Changes in the system itself are probably needed in order to avoid crisis of this kind in the future. None of the current proposals seem to meet this test.

The Third World debt problem is an unmistakable symptom of a malfunctioning system, a further signal of increasingly urgent need to pursue economic justice in the international order.

We wrote in our economic pastoral—

Progress toward that goal demands positive and often difficult action by corporations, banks, labor unions, governments and other major actors on the international stage. But whatever the difficulty, the need to give priority to alleviating poverty in developing countries is undeniable; and the cost of continued inaction can be counted in human lives lost or stunted, talents wasted, opportunities foregone, misery and suffering prolonged, and injustice condoned.

[The complete prepared statement of Bishop William Weigand follows:]

Testimony of

Bishop William Weigand
Bishop of Salt Lake City

for the

U.S. Catholic Conference

before the

Subcommittee on International Finance
Senate Committee on Banking, Housing and Urban Affairs

on

Third World Debt and U.S. Policy: Ethical Reflections

April 1, 1987

Mr. Chairman: I testify today on behalf of the U.S. Catholic Conference (USCC) the public policy arm of the Catholic Bishops of the United States. I express the appreciation of the USCC for the invitation to appear before this Committee. I welcome the opportunity to offer some remarks on behalf of the USCC on the increasingly serious and urgent problem of the debt of the Third World countries, which now stands at \$1.035 trillion, according to the World Bank.

I am sure you are aware that last November the U.S. Catholic bishops approved a pastoral letter on the U.S. economy, entitled "Economic Justice for All." I had the privilege of serving on the ad hoc committee of five bishops who spent several years preparing the draft of that document. During those five years the committee members were exposed to a broad range of opinion on the economic policy issues we had chosen to address -- one of which, The U.S. Economy and the Developing Nations, included the subject of this hearing.

As USCC witnesses have pointed out to other Congressional bodies, our Catholic tradition recognizes the crucial importance of the kind of empirical analysis and technical competence on issues of public policy that have been presented to this body; these are clear prerequisites for reaching fair and effective decisions on these complex issues. During the preparation of our letter we, too, conducted a series of hearings at which economists and others gave us valuable insights into how the economic system works and how it might be improved.

But we believe that the economic analysis must be

complemented by a moral perspective that reflects the human needs, the real people, the human problems, behind the statistics and the economic indicators. Economic decisions affect human persons and are therefore fundamentally moral.

The argument of our pastoral letter rests on three premises: first, the dignity of the human person created in the image of God is the measure against which every economic decision, policy, and institution must be judged; second, because this human dignity can be realized only in community, every person has a right to participate in the economic life of the society; third, all members of the society have a special obligation to the poor and the disadvantaged. For us, the ultimate test of justice is how the economic policy choice affects the poor.

We find ourselves, therefore, at the intersection of empirical economic analysis and the normative questions of values and human purpose. While we acknowledge that our three perspectives do not lead directly to specific conclusions about policy -- that is, that there can be no purely moral approach to economic choices -- we nevertheless insist that purely empirical economic analyses cannot produce, by themselves, an adequate policy, either.

The formulation and implementation of economic policies cannot be left solely to technicians, special interest groups, and market forces; it must also centrally involve ethical values and moral priorities. We also believe that the perspective of Catholic teaching provides a point of entry and an angle of

vision distinct from, and an indispensable supplement for, that of the professional economist.

We decided to treat the Third World debt situation, at least briefly, in our letter partly because the dynamic of our process and the thinking I have just summarized led us in that direction -- and partly, too, because our discussions with our fellow bishops from Latin America and the many communications we have received from American missionaries serving in the Third World added a note of personal urgency to the more detached conclusions of our analysis.

We believe very strongly that a debt burden which resulted in a net transfer of nearly \$30 billion in 1986 to the industrialized countries (principally to the United States) from countries in which upwards of 800 million people live in poverty so miserable that it is "beneath any rational definition of human decency," in which hundreds of millions of people are chronically hungry, in which 40,000 children die every day from malnutrition and disease, in which two-thirds of the world's people live at an economic level that is increasingly below that of the industrialized world, is much more than a set of problems calling for a technical solution. It is a scandal; it calls for a moral solution that should entail significant sacrifices on the part of those who benefit materially from this situation.

In the international section of our pastoral letter we acknowledge, in the first place, what we term "The Complexity of Economic Relations in an Interdependent World." We say that these economic relations constitute "the framework in which the

solidarity we seek on a national level finds its international expression." Although we recognize that the United States has economic relations with a whole spectrum of other nations, "our emphasis on the preferential option for the poor moves us to focus our attention mainly on U.S. relations with the Third World." Among those relations we give considerable prominence to international finance: "The debtor-creditor relationship exemplifies both the interdependence of the international economic order and its asymmetrical character, i.e., the dependence of the developing countries."

Although I am sure you are as aware as we are of the nature, dimensions, and causes of the present Third World debt situation, I believe it would be useful anyway to indicate to you how we see this matter from the angle of vision noted above.

The total aggregate debt of the developing countries has now gone beyond the \$1 trillion we cited in our letter. The servicing of this enormous debt (the largest part of which is interest) entails an outflow of capital so huge that for all practical purposes it inhibits those countries' development -- whether development is viewed as economic growth or as improvement of the quality of life of poor people (which would be our preferred definition).

One might think from accounts in the media that the so-called debt crisis burst full-blown and unexpectedly on the world in August, 1982, when Mexico announced that it could not meet its debt servicing requirements. In fact, however, as you know, it had been accumulating throughout the 1970s at least, as food and

energy prices rose sharply and newly rich oil-exporting countries invested their profits in the banks of the industrialized countries. Developing countries borrowed these funds to pay their increased energy and other import bills -- and then borrowed again -- often at variable interest rates -- when oil prices doubled once more at the end of the decade and falling prices for their commodity exports reduced their ability to service the debts incurred earlier.

Already at the beginning of the 1980s, before commercial lending began to decline and nearly three years before the Mexican announcement, the Brandt Commission noted that the borrowing needs of even the better-off developing countries were likely to rise considerably during the ensuing decade, at least partly because they would need to borrow more in order to service the debt already accrued. The Commission went on to observe that "The debtor economies and the entire international credit structure are now very vulnerable to any disruptions in the flows of capital." "The heart of the debt problem," the commissioners wrote, "is that a very large proportion of the funds are lent on terms which are onerous for borrowers from the point of view of both the repayment capacity of the projects they finance and the time debtor countries need to correct structural imbalances in their external accounts."

What is not always recognized is that developing country borrowing in the 1970s saved the industrialized countries from the full impact of the oil price rise. "Over the last few years," the Commission continued, "economic activity in the

industrialized countries has been sustained by a major recycling of financial surpluses through the commercial banks." The Commission quoted an OECD (Organization for Economic Cooperation and Development) report that says "Had developing countries followed the example of industrialized countries after 1973 by cutting back both their growth and imports to adjust to the oil price increase, the recession in the industrialized world would have been far more serious."

In other words, these countries of the South bailed out the industrialized countries of the North by quadrupling their own external debt in the decade of the 1970s. When oil prices doubled again in 1979, they were unable to repeat that performance, especially during the recession that ensued and as interest rates rose and the terms of trade worsened for their exports. At the end of 1979 their debt was about \$300 billion; the Brandt Commission estimated that another \$500 billion might have to be added by 1985 unless the oil-importing countries checked their imports and their growth -- "provided the funds could be found." As is manifest in the trillion dollar total, those funds were found, at least until very recently.

The Brandt Commission's prescription for relief was "massive transfers" of resources through concessional foreign aid and commercial lending, which would require "intermediation" by public institutions like the World Bank and the International Monetary Fund (IMF), since "private commercial banks...can no longer be counted on to conduct the recycling process unassisted." "All countries must share the burden," the Commission said and called for, among other

things, a system of universal international taxation.

As we now know, all countries have not shared the burden; commercial lending has dwindled to a trickle; there is a large and growing net transfer of financial resources (nearly \$30 billion last year) from poor people and poor developing countries to relatively rich industrialized countries and relatively rich people; the catch-phrases of the day are "policy reform," "structural adjustment," "conditionality," and "austerity." What these phrases mean, in practice, is lower living standards, increased malnutrition and poverty, higher unemployment, rising infant mortality, and general damage to vulnerable groups in the debtor country.

This, in our summary view is the historical record. The prescriptions of the Brandt Commission -- and most others being considered now -- are either macroeconomic solutions, which do not take the human element adequately into consideration, or Band-aids (some of them quite large) which treat only the symptoms, or efforts to lighten the debt burden so that these countries can buy our exports. As we wrote in our pastoral letter, however, the Third World debt crisis reveals a more fundamental systemic problem. What happened in the 1980s, like what happened in the decade before it, resulted not only from policy but from structure. None of the debt solutions now being offered -- whatever their other merits might be -- seems to address this underlying problem of the system itself.

The broad outline of the post-World War II international financial system was established at the Bretton Woods Conference

of 1944, which created the World Bank and the IMF and laid the foundation for the GATT (General Agreement on Tariffs and Trade). The purpose of these arrangements was to prevent the kind of economic action that were perceived to have led to the war. In the system that emerged the dollar was the dominant currency, much as the British pound sterling had been in the inter-war period; and its role as the basic medium of exchange led to nearly three decades of unprecedented economic growth and prosperity. Even after the United States terminated payment in gold, the dollar remained the dominant currency -- throughout the period and to the present day. As the dollar appreciated in price and dollar-denominated loans were rescheduled at higher interest rates (and with high rescheduling fees for the banks), the burden on the debtor countries grew steadily worse until it reached its present dimensions.

Especially after the Mexican crisis of 1982, the rather limited number of major lenders (a score of them in the United States) began to worry about the high proportions of their portfolios that were in Third World loans; the particular fear was that a major debtor might default, wipe out an important bank, and trigger a damaging process in the international financial system. From the debtors' side of the table (the perspective we emphasize in this testimony) the continuing payments are seen as threatening social stability in debtor countries, slowing down economic growth, and hindering efforts to improve the living standards of the poor.

For many of us who are concerned with this problem of

Third World debt, there is the further complication of how at least some of the borrowed money was spent. It is documented, for example, that capital flight from Third World countries has increased, as ruling and economic elites transferred funds into high-interest-paying accounts and investments in the industrialized countries. There are numerous -- and notorious -- examples. The very banks that are paying interest on the foreign accounts of those elites are obtaining much of the money to do so by further penalizing and taxing workers and farmers in these developing countries that are continuing to meet their debt service burden. Then, when, as in 1982, a major country gets into difficulty, the banks either cease lending (but continue to insist on payment and therefore earn profits) or are cajoled into rescheduling loans, for which they increase the spread between the interest they pay on deposits and the interest they collect on the loans (and charge high fees for doing it).

It seems to us that the injustice in these circumstances is rather clear: first, poor people in poor countries are forced to pay back debts pushed on their not uneager but often unrepresentative governments by profit-seeking banks in the industrialized world; second, poor countries which shored up the industrialized world after the first oil shock, but could not do so after the second, are now required to continue -- and in fact, increase -- the net transfer of resources to the relatively rich North; third, workers and farmers in countries like the United States are losing jobs, income, and assets because their former customers either cannot afford to buy their products in view of

the required debt repayments or are competing in those very markets in order to earn foreign exchange to pay back the debts; fourth, the bulk of this debt is interest, not principal. (Some, particularly in the Third World, ask whether the front-loading of interest in these circumstances could be considered usury.)

A Joint Economic Committee (JEC) report of last May, for example, estimated that U.S. agricultural exports to Latin America declined one third, prices of exported farm commodities fell about 20 per cent, and competing grain exports from Latin America more than doubled -- all because of the debt crisis of that region. The Brandt Commission was quite right to say: "All countries must share the burden." We would take it one step further: the creditor institutions, in particular, must share the burden, because they have profited the most from it.

In the midst of this malfunctioning system the IMF rose to quick and unexpected prominence in 1982. Originally established to provide short-term credit to countries that were having difficulties with their balance of payments, the IMF found its time frame unexpectedly lengthened because of the systemic problems that were emerging -- and thus was pushed into the role of a development agency. But the IMF's standard formula for meeting the short-term liquidity problems did not change: devalue the currency to encourage exports by lowering their price and thus earn foreign exchange; hold the line on wage increases to reduce the incentive to consume (and thus compete with exports); remove price controls and increase domestic interest rates to stimulate production for export; and cut consumer

subsidies and public services to reduce inflation and the budget deficit.

These are the "austerity" measures associated with the IMF's standby agreements; the IMF insists that it does not "impose" these conditions. Moreover, former IMF Managing Director Jacques de Larosiere, at the World Bank/IMF meeting last fall expressed concern about "the most pernicious human costs" of the debt problem after having told ECOSOC last summer that a successful strategy must also "pay attention to the health, nutritional, and educational requirements of the most vulnerable groups.... For example, safeguarding human needs may imply that employment in overstaffed and loss-making public enterprises or defense spending be reduced in preference to cutting an accelerated immunization and health care program for children." There is little evidence, however, that this approach has yet carried over consistently into IMF practice.

In fact, the Third World debt problem up to now has been handled on an ad hoc basis by the IMF, the World Bank, the Federal Reserve Board, the Treasury, and, with considerable reluctance, the commercial banks. Notwithstanding M. de Larosiere's statements, the solutions have therefore been bankers' solutions; they have treated the matter solely as a macroeconomic problem and have emphasized economic growth, generally ignoring equity considerations altogether. The question has been posed this way: "how can the indebted countries achieve sustainable growth while continuing to make progress toward the restoration of normal debtor-creditor

relationships?" The result of operating from this angle of vision has been that in order to sustain the same level of bank profitability (not just the soundness of the financial system), the IMF and its collaborators have insisted that foreign creditors of these debtor countries be paid in full and on time, even at the cost of reduced living standards and declining real incomes for the poor, increasing unemployment, steep price rises for food staples, and in some cases repression of fundamental human rights.

I fully agree with M. de Larosiere that "further progress on the debt problem depends critically on each of the major parties pulling his weight. Co-responsibility (used in his November 21 speech somewhat before it appeared in the recent Vatican document on debt) must therefore remain the cornerstone of the strategy. Second, a satisfactory solution to the problem...is feasible only in the context of durable growth in the debtor countries." I would add that such growth is unlikely and certainly undesirable without an at least commensurately equitable sharing of benefits and the decisions about them by the poor majorities in those countries. The international financial system should not be saved by the two groups least responsible for the current crisis -- the poor in the Third World and the taxpayers of industrialized countries like the United States (who will pay the bill if governments must shore up improvident banks).

I am pleased to see that many are beginning to recognize that the creditors must accept a share of the sacrifices needed

to resolve the Third World debt crisis. It is necessary, however, to look carefully at two kinds of debt problems, at least. The first is that of, mainly, Latin American countries, which account for "roughly 40 per cent of the total external debt of all capital importing countries." Between 1981 and 1983, according to the IMF, net commercial lending to Latin America dropped from \$55 billion to \$1 billion, import volume decreased by 40 per cent, unemployment rose, and for all practical purposes growth stopped. More recently we have all noted the dramatic announcements and actions by Mexico, Brazil, and Argentina. These events seem to be one more set of clear indications that the policies followed up to this point, in addition to being unfair, are also ineffective.

The debt of Sub-Saharan Africa, on the other hand, poses a quite different problem. The bulk of it is owed not to commercial banks, but to governments or to the multilateral institutions created by governments -- the World Bank, the regional banks, and the IMF. As we pointed out in our pastoral letter, "although their aggregate debt of about \$100 billion is only a quarter that of Latin America, their collateral (oil, minerals, manufactures, grain, etc.) is much less adequate, their ability to service external debt much weaker, and the possibility of their rescheduling it very small." In this case we believe that "forgiveness," perhaps in the guise of converting this official debt to a local-currency obligation to be paid into a development bank in the country, would be an appropriate and effective solution. Criteria for such conversion would, of

course, have to be very carefully studied.

As we noted at several points in our letter, moral principles and doctrinal positions do not yield specific policies. They do not tell us, for example, which to choose among the dozens of solutions proposed for this problem. But they do offer some general benchmarks against which to judge those proposals. We would look with great skepticism, for example, on solutions whose major objective and expected result would be to assure the creditors payment in full, or on proposals that consider the present problem one of temporary liquidity rather than incipient insolvency and would therefore increased lending to "stimulate growth."

In our view, none of these measures, as currently described, would improve the lot of the poor over time, since all of them are designed more to tinker with the system than to diagnose and deal with it in depth. The people least able to pay these debts and most burdened by them would not be helped by any of these proposals -- except, perhaps, in the now discredited sense of "trickle-down." We strongly agree with the view Senator Sarbanes expressed a couple of months ago that "instead of simply lending more, we need to give greater attention to reducing the outflows associated with the existing debt." It is the existing debt itself that needs to be reduced.

A new contribution to the debt debate is the recent publication of the Pontifical Commission *Justitia et Pax*, "At the Service of the Human Community: An Ethical Approach to the International Debt Question." In his introductory presentation,

Roger Cardinal Etcheagaray, President of the Commission, after summarizing the history of the crisis in much the same terms the U.S. bishops used, writes: "When credit agencies consider the situation solely from the economic and monetary angle, they often impose on the debtor countries terms, in exchange for accrued credit, that can contribute, at least in the short term, to unemployment, recession, and a drastic reduction in the standard of living. This causes suffering, first of all for the poorest as well as for certain sectors of the middle class. In brief, it is a situation that is intolerable and, in the medium term, disastrous for the creditors themselves. Debt servicing cannot be met at the price of the asphyxiation of a country's economy, and no government can morally demand of its people privations incompatible with human dignity...economic structures and financial mechanisms are at the service of the human person and not vice versa..."

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The first of the ethical principles enunciated by the Vatican document is the very term used by the Managing Director of the IMF in his speech quoted above: co-responsibility. Both the U.S. bishops' letter and the Vatican document emphasize that "in order to be just, interdependence should give rise to new and broader expressions of solidarity which respect the equal dignity of all peoples... Solidarity implies an awareness and acceptance of co-responsibility for the causes and the solutions relative to international debt...the various partners must agree on an equitable sharing of the adjustment efforts and the necessary sacrifices, taking into account the priority to be given to the

needs of the most deprived peoples. It is the responsibility of the countries that are better off to assure a larger share." ("An Ethical Approach")

The Pontifical Commission's document spreads this co-responsibility rather widely: "Due to their greater economic power, the industrialized countries bear a heavier responsibility, which they must acknowledge and accept." (Politicians are called on specifically to form public opinion in this area).

Groups in authority in indebted countries must be willing "to explain their own actions, errors, and even abuses" and avoid the temptation to "shift full responsibility to other countries" so that they will not have "to propose any changes which would affect them directly." They must also "accept having their actions and any responsibilities they may have in their countries' indebtedness scrutinized (and must)...promote sustained economic growth...in order to ensure a broader and more just distribution among all..."

Though "creditors have rights, acknowledged by the debtors..., creditor States have to find reimbursement conditions which are compatible with each debtor State's ability to meet its basic needs..."

Commercial banks are urged to finance "projects on the basis of their impact on growth in preference to 'safer' projects with more immediate investment returns," even though this approach "goes beyond the traditional function of commercial banks insofar as it invites them to undertake a type of

discernment which transcends the ordinary criteria of profitability..."

"Multinational companies have extensive economic, financial and technological power... As economic and financial actors on the international stage, they are called to co-responsibility and solidarity which is above and beyond their own vested interests."

Finally, the multilateral financial organizations "are faced with new and urgent responsibilities: to help solve the debt crisis of the developing countries; to avoid a generalized collapse of the international financial system; to help all peoples, especially those in greatest need, to bring about their own development; to combat the spread of poverty under all its various forms and thereby promote peace by eliminating the threats of conflicts..."

The link which the Vatican document establishes between a just solution of the debt problem and social peace is crucially important. Although the debt crisis has coincided with -- or perhaps even partially caused -- considerable democratization in Latin America during the last few years, as mismanagement by authoritarian ruling groups was revealed, there is a danger that the austerity associated with IMF standby agreements and commercial bank pressure for full repayment may push these fledgling democracies to adopt unpopular policies that could lead to a revival of authoritarianism to enforce the austerity programs. Thus the banks may be pitting themselves, unwittingly against the very forces in the debtor countries that could

provide a democratic, growth-with-equity alternative. Democracy is threatened by the debt crisis.

Our discussion here today, as well as much of the analytic material in our pastoral letter, has a dispassionate, even clinical, tone. We hear a different voice in letters from American missionaries overseas, like one that came in recently describing the missionary's return to the mission country after some period of time: "Today I rode the bus downtown, for which I paid 250,000 pesos...When I was here ten years ago, I could have brought the bus for that price." As Maryknoll missionary Father Tom Burns said of his parish in a poor suburb of Lima to another Senate committee last month, "Peru used to be a culture of struggle, with hope. It's become a culture of survival." Later on, speaking of changes in purchasing power and employment, he said: "The human impact of such statistics is devastating. In my parish, after a sudden rise in prices, I met a woman in the market. She looked at me and then back at her empty hand, and said, 'Bless me father, so that we won't have to eat.'" And still later he described the frustration of young people finishing secondary education: "the only choices they have are to become ratero, coccalero, o de Sendero (a thief, a cocaine trafficker, or a terrorist (member of the Shining Path -- a terrorist group))."

We also hear a different voice when we meet with Latin American bishops on these issues, as we did a year ago in Miami. The "cool" analysis of the debt problem became immediate, personal, passionate, and urgent when we heard a Brazilian

bishop, for example say: "Your debt is an iron ring around the necks of my people." These bishops had two major financial problems on their minds -- the debt, and capital flight. They were very hard on their own political and economic leaders for pushing money out of the country into those attractive overseas investments, but almost equally hard on the industrialized countries for placing those profit temptations in their paths.

I worry a little about the almost exclusive focus on the debt problem in hearings on Capitol Hill, as well as about the tendency to view it in tandem with the trade problem -- as if to suggest that the main or only reason for relieving the debt burden is to make it possible for the debtor countries to buy our exports and thus relieve some of our own economic problems. We do not believe the Third World debt problem can be solved without addressing all aspects of the international order. We said in our pastoral letter on the economy that "We believe that U.S. policy toward the developing world should reflect our traditional regard for human rights and our concern for social progress. In economic policy, as we noted in our pastoral letter on nuclear war, the major international economic relationships of aid, trade, finance, and investment are interdependent among themselves and illustrate the range of interdependence issues facing U.S. policy... Each relationship offers us the possibility of substantial positive movement toward increasing social justice in the developing world..."

In the debt area, as with the other three -- trade, aid, and investment -- the problem goes beyond even the system

itself. "It afflicts and oppresses large numbers of people who are already severely disadvantaged. That is the scandal: it is the poorest people who suffer most from the austerity measures required when a country seeks the IMF 'seal of approval' which establishes its creditworthiness for a commercial loan (or perhaps an external aid program). It is these same people who suffer most when commodity prices fall, when food cannot be imported or they cannot buy it, and when natural disasters occur. Our commitment to the preferential option for the poor does not permit us to remain silent in these circumstances..."

We are aware that neither of our two pastoral letters prescribed a policy solution to the problems it focuses on. We think that is proper. The virtue of prudence enters the equation as soon as one moves beyond the realm of principle. We see these two letters as inextricably linked; peace is, after all, the fruit of justice. We know that just as what the peace pastoral recommended in a general sense would call for a very different policy from the one the United States is following today, so would the economic pastoral. But just as one effect of the peace pastoral was to identify the Roman Catholic community with the effort to reverse the arms race and stem the dangerous drift toward nuclear war, one effect of the economic pastoral will, we hope, be to identify the Roman Catholic community with the cause of economic justice -- especially for the poor, both in the United States and in the Third World.

How that objective is to be achieved is, of course, a matter of debate on many issues. One of them -- possibly the

most urgent and intransigent -- is the question we are discussing today.

In our pastoral letter we mentioned a number of possible approaches to this problem, but we don't have a formula to propose to you. Moreover the debate is moving rapidly on many fronts; one recent estimate suggests that 60 solutions have been proposed. Nevertheless, we would like to suggest several principles which we and many other religious groups believe should underlie a normative approach to a solution to the problem of Third World debt:

1. Responsibility for the solution must be shared in an equitable fashion by both creditors and debtor countries, and the burden must be lifted from the poor. This is the principle of co-responsibility which appears in our letter and is emphasized by the Vatican document.

2. The primary objective must be to improve the quality of life of the poorest people through restored and equitably shared economic growth, not to preserve the current level of profitability of banks.

3. Criteria for adjustment of each country's debt situation should take into account, among other things, what the money was borrowed for, how it was used, what efforts the debtor country has already made or begun to repay it, and how the debtor nation proposes to stop capital flight.

4. Any structural adjustment or other debt-solution package must preserve the basic human rights of the citizens of the debtor country and the integrity of its government.

Senator SARBANES. Thank you very much, Bishop, and thank you for an exceedingly thoughtful and perceptive statement. We appreciate it very much, and of course, the full statement will be included in the record.

Mr. Rogers.

STATEMENT OF WILLIAM D. ROGERS, SENIOR PARTNER, ARNOLD & PORTER, FORMER UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. ROGERS. Mr. Chairman, you are pressed for time. I will submit my statement for the record, if you will. It is an attempt to address the significance of the economic crisis, particularly in Latin America, for our overall world foreign policy interests.

I would, however, like to read one very telling and somewhat ironic statement by Mario Vargas Llosa, the Peruvian writer, who himself addresses the same issue and the relationship of the United States to the effort to preserve democracy in Latin America, which is vitally affected by the economic crisis in the region. He says:

When a Latin American nation chooses democracy, it not only chooses freedom and the rule of law, but the most extreme form of independence as well. This is because no other type of government receives less support from the West . . . than those regimes in the third world that try to live the ideals of freedom and pluralism which are the West's greatest contribution to the world.

[The complete statement of William D. Rogers follows:]

Senator SARBANES. Thank you. Gentlemen, were you here for the previous panel?

Mr. ROGERS. I was here for part of it, Mr. Chairman.

Senator SARBANES. Let me put this question to you. I thought, with the exception of Ms. Shelton-Colby, that there wasn't a sense of urgency about this problem, and I wonder whether you perceive it in the same way, both the broader sense of urgency, which I think Bishop Weigand, you very much addressed yourself to, but also even a more narrow, shorter range view of urgency, as it may even involve the very self-interests of the people who are treating it with some—who are being fairly sanguine about it.

I wonder if you had a reaction of that?

Mr. ROGERS. Well, I think, without attempting to state the matter in excessively flamboyant terms, we are sitting on the edge of the possibility that one or another of the economies of the major nations of the region will break down because of the burdens of the economic crisis that they face, that this could lead to both a lurch away from the democratic path which the major nations are presently following, and at the same time, drive that country out of the international economic system in a way which would make it impossible for that country to continue trading, because of the drying up of trade credits attendant upon a default of its debt servicing.

I think this would be the most significant blow to U.S. relations in Latin America in the last 200 years. And as I say, without attempting to be excessively nervous or apprehensive about that, the distinct possibility that that could occur, I think, really needs to be borne in mind by all serious policymakers who treat this issue.

Senator SARBANES. Bishop, did you want to comment about that?

Bishop WEIGAND. I also, Mr. Chairman, detected a tone of lack of urgency; however, I am slightly apologetic for my own statement, the written statement, even the pastoral letter and the Vatican's recent document on the world debt, because these things tend, without us wanting it to be written in rather clinical terms and do not stress the urgency of the people suffering under the systems and the potential breakdown of the systems. I did think that Ms. Shelton-Colby's remarks were on target—I could identify with them very quickly.

Senator SARBANES. Well, I notice in your statement, in fact, you make that very point, I thought, very effectively, when you said that—and I am quoting you now in your statement—"The cool analysis of the debt program became immediate, personal, passionate and urgent, when we heard a Brazilian bishop"—this was at a meeting between the Latin American bishops and U.S. bishops in Miami—"when we heard a Brazilian bishop, for example, say 'Your debt is an iron ring around the necks of my people.'"

Bishop WEIGAND. That is correct, and I might—following up for just a moment on Mr. Rogers, my own experience in Latin America, and granted it was limited to one country, but I found the people, generally, apart from the bad names that they always give to the CIA, were rather pro-American, pro-United States. And I think the way the debt situation is handled and how long it is allowed to go without any lifting, even a partial lifting of the burden upon the masses of people, will quickly deteriorate that good will that we have in just so many of the people.

5. Any viable solution must recognize and relieve external factors beyond the control of the debtor country that tend to aggravate and perpetuate the burden -- interest rates, commodity prices, trade barriers, budget deficits, etc. In no case should the solution increase the debt.

6. Some immediate benefit should be obtained by the debtor countries especially for the poor.

7. We need to look very deeply into the entire system of international finance as we try to solve these immediate problems; changes in the system itself are probably needed in order to avoid crises of this kind in the future. None of the current proposals appears to meet this test.

I would like to conclude with some views we expressed in our pastoral letter on the U.S. economy about the pursuit of economic justice in the international order, which apply with particular cogency to this issue. "Progress toward that goal demands positive and often difficult action by corporations, banks, labor unions, governments, and other major actors on the international stage. But whatever the difficulty, the need to give priority to alleviating poverty in developing countries is undeniable; and the cost of continued inaction can be counted in human lives lost or stunted, talents wasted, opportunities foregone, misery and suffering prolonged, and injustice condoned."

That is why we believe hearings like this are important. I hope that some of these reflections will be helpful to you in your deliberations. Thank you for your attention.

TESTIMONY OF WILLIAM D. ROGERS
SENIOR PARTNER, ARNOLD & PORTER
TO THE INTERNATIONAL FINANCE AND
MONETARY POLICY SUBCOMMITTEE OF THE
BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

APRIL 1, 1987

I have been asked to say a few words about the significance of LDC debt for American foreign policy.

I am here in my private capacity. I and my firm represent the government of Brazil and its Central Bank on international financial matters, including debt restructuring. I do not speak for Brazil today, but rather from the perspective of my own personal experience.

Other witnesses have and will treat the financial and trade dimensions of the problem. I will not, therefore, say very much about the importance to the United States of the preservation of the international financial system, which is so fragile and which would be so directly affected by a default by a major LDC debtor. Nor will I say much about the zero-sum-game trade-off between U.S. banks and U.S. exporters inherent in the obligation of those nations to service their large debt burden at floating rates of interest each year.

My focus is the overriding foreign policy interest of the U.S. in finding a way out of the economic crisis of the major developing countries. That

interest is engaged primarily in Latin America, since the Latins account for the bulk of the sovereign debt now in difficulty. But virtually everything that can be said about Latin America is also true of the Philippines, which is the other major democratic debtor facing payment problems at the present time.

My basic view can be stated succinctly: The political stability and development of Mexico and the major nations of South America is a senior priority of our foreign policy -- or should be. Economic crisis directly threatens the cohesion of virtually every country in this Hemisphere. There is a good deal of rhetoric around this town about the need to preserve democracy in Latin America. If you want to strengthen democratic hopes in Latin America start with the debt of the big countries.

It is difficult to overstate the impact of the current economic condition of the region. Its consequences are universal throughout Latin America and the Caribbean -- and pernicious as well. Absolute declines in standards of living, reductions in nutritional standards of the young, strained public sector budgets for education, infrastructure, services. The economic progress of the Seventies has evaporated. The Hemisphere has been set back ten years in its struggle against poverty, disease and ignorance.

Are democracy and recession indefinitely compatible in Latin America? I don't know. It has been astonishing that despite the brutal economic punishment inflicted on people of Latin America in the last five years since the debt crisis exploded, no democracy has been overthrown anywhere -- with the single exception of Panama.

Yet the common sense and shared experience of mankind suggests that poverty, frustration and hopelessness are scarcely a healthy base for any political system. And by its very definition a political system based on the will of all the people is more susceptible to a rise in general dissatisfaction and frustration than authoritarian regimes. Growth, and the prospect of an improved life, by the same token, breed confidence and support. It is impossible to say when the breaking point may occur. But occur it more probably will as long as the generality of Latin America faces a future like the immediate past, in which the prospects of growth are dim and the hopes for a better life evanescent.

This would be a body blow to our foreign policy. I have no doubt that the survival of the democracies of Latin America is a matter of profound interest to this country. The decisive break with the past, the commitment to freedom in Brazil, Argentina, Uruguay,

Peru, Ecuador, Bolivia and the Dominican Republic in this decade, the end of military governments, the establishment of free press, the lively contention of competitive political parties -- in these we are witnessing a new chapter in the history of our Hemisphere, and one of the remarkable human victories of our age. It has been happening right before our eyes, in our home Hemisphere. Those who love freedom have been winning a great struggle.

And yet the perception in Latin America is that the United States is distracted elsewhere. We are not seen as a part of the process of democratization. As the Peruvian writer, Mario Vargas Llosa has said recently, "When a Latin American nation chooses democracy, it not only chooses freedom and the rule of law, but the most extreme form of independence as well. This is because no other type of government receives less support from the West . . . than those regimes in the third world that try to live the ideals of freedom and pluralism which are the West's greatest contribution to the world."

This is not the time for the United States to be on the sidelines. We should be, and we should be seen in Latin America as being, in the thick of the struggle to maintain democracy. At stake are 325 million people and the nature of the political systems under which they

may live for a long time to come, the stability of nations with immense resources, the viability of states occupying some very strategic real estate. If they conclude that democracy cannot deliver the political stability and economic growth they demand, we will have sustained a severe setback in the global struggle. In the geostrategic interest of the United States, Brazil equals twenty-five Nicaraguas.

U.S. policy in this Hemisphere suffers from recurring bouts of engagement and retreat, of cycles of commitment interspersed with periods of preoccupation elsewhere. The high water marks in our relationship with Latin America in this last half century have been the Good Neighbor Policy and the Alliance for Progress. These were both based on a conscious realization that the economic growth of the region and its political development would make for a better world, one in which the national interest of the United States would be enhanced. Those essential truths remain as true today as they were in 1934 and 1961.

I should not like to be misunderstood. External circumstances, particularly the U.S.-lead rise in international interest rates, the fall in commodity prices, the slowdown in the OECD countries and the sudden shutting of the loan windows at the private banks were the major reasons why Latin America's borrowings in

the late 70's and early 80's could not be serviced in the years beginning with 1982. The political developments in Latin America, on the other hand, were entirely indigenous; it is the Latins who made the choice and deserve the credit for the move to democracy. And by the same token the preservation of the tender political experiment and the creation of economic conditions within which democracy can flourish will depend largely on the efforts and the commitment of the people of Brazil, Argentina, Mexico and Venezuela, among others. But we can help.

It is a matter of primary national interest that we do so.

I worked in an area among the poor, for instance, in the aftermath of the Alliance for Progress, and the United States was very much loved and respected and the projects that were done, mostly in our area, schools, schools for the children that got them off the streets and out of dirt-floor, bamboo schools, and in some cases, no schools. It was an ongoing credit to the United States the compassion with which the people had been dealt with through programs of that kind and a great, I might add, a great bulwark against the constant tendencies toward neo-Marxist kinds of movements.

I periodically had groups of Marxists come in to my parish area to try to stir up people, and they would pay no attention whatsoever, because of our presence there, our commitment, and in a sense, how they saw us representing the United States.

I just dreadfully hate to see all of that history deteriorate into a different kind of picture.

WHO SHOULD BEAR THE BURDEN OF DEBT RELIEF?

Senator SARBANES. Gentlemen, assuming you wanted to proceed down a path to relieve the debt overhang, provide a breathing space, who should pay for that and how should it be paid for? Who should bear the burden of doing that, not only in a broad sense, the creditor nations and their institutions, because obviously, that is where it would have to be, if you are going to diminish the burden on the debtor nations and their institutions, but amongst the creditor nations and amongst their institutions, where should that burden fall? Where is it reasonable to expect a contribution toward that burden?

Mr. ROGERS. Let me take a crack at that, Senator, if I may. First, let me make it very clear that I am testifying on my own behalf rather than on behalf of some of the clients of my firm, which include some of the major debtors of the world—Brazil, Venezuela, others.

In terms of a resolution of the crisis, one has to think about it as a package. Resource transfers are an important, but only a part of that package. The total package of policies by the West, it seems to me, must include macroeconomic policies which are more harmonious to the possibility of the debtor countries working their way out of the debt crisis. By that, I specifically mean a resolution of the budget deficit in the United States, which I think is the most serious burden that we impose on the world economy, with distinct effects, specifically in the developing world.

Second, a maintenance of open markets in the United States and massive opportunities for exports here.

Our trade policies, although we compliment ourselves over and over again with respect to openness, are still of considerable negative impact on the developing world. Mr. Andreas mentioned the EEC sugar policy, but you don't need to go very far from Washington to see bad sugar policy. United States sugar policy is quite restrictive, to say nothing of U.S. policy with respect to textiles and steel and others.

Protectionist restraints are already having an effect on the export potentialities of Mexico, Brazil, and the other major countries.

Those two points, it seems to me, are very important, in addition to the resource transfer question.

RESOURCE TRANSFERS

Now in terms of resource transfers, it clearly should come in a very major way, in my judgment, from the taxpayer. I mean that quite explicitly and concretely, even to the extent of imposing measures on the banks which make them more capable of sustaining a slowdown in debt servicing. In the European case, where the reserving process has gone much further than it has with banks in the United States, write-downs are largely financed out of tax forgiveness. Our tax policy, in terms of treating reserving by the banks, with respect to low quality LDC debt, is much less favorable to the banks, in terms of tax remission than the European policy is. That is the reason why the European banks are in a much stronger position with respect to their reserves for LDC debt.

My short answer to your question, in other words, is that with respect to resource transfers if there is going to be a massive increase, it needs to come out of the public till, because it is public policy that is involved here.

Senator SARBANES. Now we heard testimony this morning that some of the banks are using an imperfect secondary market, in order to sell off their debt at a discount, but of course, the person buying that debt doesn't pass the discount on to the debtor country, he holds it at face value, I guess, with the speculative hope that he's going to be able to recover all of it or certainly more than what he paid. The debtor country remains where it was. I mean, its position is not improved.

Do you have any ideas on how to establish a connection. If the bank is going to take a hit by selling at a discount, is there some way to pass that discount on to the benefit of the debtor country?

Mr. ROGERS. There are lots of ways to do it. Secondary debt facilities financed by a variety of ways. My own answer to the question really comes back to the answer to the previous question, and that is, I think to do it in a way that does not do massive damage to the international financial system and the banking system in the United States, it needs to be publicly financed.

Senator SARBANES. Yes. Bishop, did you have any thoughts on this question?

Bishop WEIGAND. Your own plan or proposal, Senator, works in that direction, and we would certainly be—the U.S. Catholic Conference—on the side of some way or other, whatever mechanism that the discount would be passed on, to lift a part of the heavy burden on the debtor countries.

Now the specific proposals, your own, and there could be many others, we will not enter into, but somehow that has to be done. It seems to me that it is time also for the creditors to start accepting some of the responsibility. In the Vatican's term of coresponsibility, it should not be simply on the debtor country and certainly not mainly on the poor of the debtor countries, especially in view of the history that, in so many cases, it was dictatorial regimes that supposedly made those agreements in the name of their people. We

know in our own history, when that was tried that we didn't like that at all, when unrepresentative people chose to speak for us.

I believe, practically speaking, that in the last few years, even at the height of this debt problem, that the profitability of the banks has been quite high. It is going up. It would seem very ethical to us that somehow the banks also start accepting some of the negative effects, and I suppose that means stockholders. We don't see why that would be entirely out of order, that in coresponsibility that people all up and down the spectrum start sharing responsibility.

Senator SARBANES. It was put to us this morning by—and I thought in a thoughtful statement—by Mr. Coltman, that there are two views, one, that it is a problem of liquidity, the other, that it is a fundamental problem of solvency.

Where do each of you come out on that dichotomy?

Mr. ROGERS. We won't know the answer until we are out of the problem, Senator. This is a semantic point. By definition, if we don't have an explosion, it will turn out to have been a question only of temporary liquidity. If we have an explosion, with the kind of disruption to the system that I have in my mind, then it will turn out to have been properly labeled a question of solvency.

If you want a forecast, I think we are awfully close to the latter. We are very close to the edge in a lot of these cases. This crisis has gone on now for 5 years. It has not been resolved. No country has worked its way out of its incapacity to service its debt. In fact, if anything, countries have slipped from no principal payments, interest only, to no interest payments or a slowdown in interest payments. So the situation, if anything, is getting worse.

INSOLVENCY

Bishop WEIGAND. Our sense, also, is that these countries are going in the direction of insolvency, but even from the point of view of the moral principles that we are trying in the United States, but also from the Vatican, to bring to the fore, we would say people have a right in justice to the minimum levels of human life, consistent with their human dignity, would mean when they are pressed and pushed far enough, they do not have the obligation to pay out of what is necessary to live in order to service the debt. That is being said on a world level to a clientele that is quite largely Catholic, and that somehow or other, the solutions have to be found that spreads out the responsibilities.

On the other hand, the Church is saying that there is responsibility by debtor countries who also have to acknowledge their responsibility, and sometimes irresponsibility, in decisions made, and so forth, but not at the expense of the poor, who really were not the cause of the problem.

Senator SARBANES. Do you think to address it, it needs to be put in a multilateral context and taken out of this direct debtor-creditor relationship that now exists?

Mr. ROGERS. Oh, you mean in terms of multilateral institutions? Oh, yes. In my—

Senator SARBANES. Yes, and up at the level of government. How long can we go on with the private creditors and the debtors sort of at one another, the way they are now?

Mr. ROGERS. Well, there are really four major players in any solution. One, are the debtor nations themselves, government, and the private sector. And they clearly have a heavy responsibility to reform their economic policies.

Two, of course, are the private commercial banks with their massive interests in previously incurred debts.

Three, are the governments of the OECD countries, the Western countries, and any solution must include the effective cooperation of all of those governments, not just the United States.

Four, of course, are the multinational institutions. Primarily, the Fund, the World Bank and the InterAmerican Development Bank, the Asian Bank, and African Bank, as well.

All schemes, it seems to me, must include consideration of the strengths and capacities contributed by all four of those sets of players.

Senator SARBANES. Well, gentlemen, thank you very much. You have been very helpful. We appreciate your testimony. We appreciate your patience for staying with us.

The committee is adjourned.

[Whereupon at 12:40 p.m., the hearing was adjourned.]

EXCHANGE RATES AND THIRD WORLD DEBT

THURSDAY, APRIL 2, 1987

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Proxmire, Dixon, Graham, Heinz, and Gramm.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

This morning's hearing will focus principally on the issue of Third World debt.

Unfortunately, last week, because of some time pressures, we had a panel that we were going to hear from both manufacturing and labor groups on exchange rates, and we will hear from the remaining members of that panel later in this morning's hearings, as we are anxious to have the benefit of their testimony.

Yesterday, we had the opportunity to address the Third World debt problem in the opening of the hearings on that subject that this subcommittee is holding. We have been focusing on the apparent conflict between the interests of U.S. financial institutions and U.S. exporters, producers, as we have been addressing the Third World debt question, and in my view, we need an effective effort to address the Third World debt problem in a way that—to the maximum extent possible, eliminates this conflict or diminishes this conflict.

We are fortunate this morning to hear from a number of distinguished members of the Congress who played leading roles in addressing the Third World debt problem. We will then hear from a panel of experts with ideas on the issue of Third World debt and from a panel of bank regulators and experts in the accounting field about regulatory and accounting issues which banks must deal with in managing their Third World debt holdings.

We have a long agenda this morning. We obviously would appreciate witnesses summarizing their statements.

We are very pleased to lead off with our colleague who has taken a very active role and interest in this problem and made a number of very constructive proposals, Senator Bill Bradley of New Jersey.

Senator PROXMIRE. Mr. Chairman?

Senator SARBANES. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Could I just interrupt for a minute. I just have a short statement. I have to leave, unfortunately, so I won't be able to stay for the question period.

At the start of yesterday's hearing, I said the fundamental question surrounding the international debt issue is whether it is a temporary liquidity problem to be alleviated by new loans or whether we face a situation of at least partial debtor insolvency. In the latter case, recognition would have to be given to the fact that some of the debt is bad and can never be repaid.

Witnesses at yesterday's hearings gave differing answers. One distinguished expert told us we would not know the answer to that question till we could look back on today's problems through the eyes of history. Unfortunately, we must make policy on these issues now.

The market does seem to tell us that Third World debt is not worth the face value at which it is carried on the books of our banks. This fact and prudential concern that we may, in fact, face a partial insolvency problem, led me to join Senator Gramm in authoring the International Lending Institutions Safety Act of 1987, which we introduced yesterday.

Now a little later today, the witness from the General Accounting Office, Mr. Mendelowitz, will testify, and I want to quote briefly from what he said. He said,

A number of proposals have been advanced to provide relief to LDC borrowers by granting concessions on their current loans other than by providing assistance in the form of new loans. They all involve an explicit recognition of the fact that the actual value of the LDC loans is less than their book value.

Then he says,

A prudent first step, before adopting any of the new initiatives would be for the regulators to mandate required reserves for a larger number of countries than is now the case.

And that is what our bill would do. It is designed to increase the safety of our banks, improve their flexibility in dealing with the troubling international debt situation. It would amend the International Lending Supervision Act of 1983 by directing federal regulators to estimate at least once each year an actual or real value of loans held by the U.S. banks to countries listed in either the other transfer risk problems or substandard categories. The appropriate regulator would then require that banks establish within one year, as part of their general reserves, special reserves in the amount of 10 percent of the difference between the book value of these loans and the actual or real value as estimated by the agencies.

The required reserves would be increased each year, so that over a period of 10 years the banks would be adequately reserved against the full value of the estimated transfer risk identified for such loans. As our banks become more adequately reserved against their troubled loans, they may become more willing to trade such loans at less than their face value. Over time, this could improve both the safety of our banks and lessen the debt load of the debtor nations.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you. I would like at this point to insert in the record statements of Senators Dixon and Heinz.

STATMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the subcommittee holds its third oversight hearing on Third World debt issues. Once again, we have a distinguished and knowledgeable group of witnesses before us today, and I look forward to hearing their testimony.

All those who have testified before this committee have agreed that this problem is formidable and potentially devastating to the world economy. Last year during testimony before the House Banking Committee several witnesses testified that the Third World debt crisis may be responsible for the loss of as many as 1.6 million jobs in the United States.

These Third World nations were looked upon 10 years ago as a developing world market for U.S. products. Today, their debt is partially responsible for the decline in U.S. Exports to those indebted nations and contributes to the enormous trade deficit the U.S. faces today.

For example, farm exports to neighboring Mexico dropped 50 percent from 1981 to 1983. This is a drop of \$1.3 billion due to the debt crisis in Mexico and that nation's inability to import American agricultural produce. Over the past 3 years, U.S. trade deficits with Third World nations have remained at about \$50 billion. This represents approximately $\frac{1}{3}$ of the total of the U.S. trade deficit of \$169 billion. This trade deficit is the result of debt and not the unfair trading practices we are attempting to remedy with trade legislation.

U.S. banks continue to be dangerously overexposed in Latin America and making additional loans to pay the interest on old loans without generating new economic growth in these nations does not address the fundamental problem. It is time to face the facts.

The LDC debt problems we have already experienced will grow worse, with more serious impact on the U.S. banking system, and the world economy, unless we begin to do more than simply continue to apply these band-aids.

I look forward to hearing the views of this morning's witnesses on Third World debt and any additional insight they may provide on this important subject.

STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, in this second day of our exhaustive set of hearings on the debt problem—I should say exhausting looking at the witness list—we will hear from proponents of a variety of approaches to improve on our current approach to debt.

At the outset, let me restate my view that there is no grand solution to the debt problem. Despite all the frustration with slow progress under the Baker Plan, recovery from debt problems depends on reform in debtor countries supported by sufficient financial support by creditors and worked out on a case-by-case basis. This is not to say that I am content with the status quo. The Baker

Plan is working better in concept than in practice, and to some extent its immutable formula for new lending has throttled innovation.

I would have to say, however, that the alternatives being offered have problems as well. Debt forgiveness is proposed through publicly funded debt facilities or writeoffs enforced by regulators. These proposals seem to offer modest debt relief, limited policy change, and high cost to taxpayers. Other proposals focus only on U.S. bank soundness. As reserves are built up for loans to all troubled debtors, our concern about the banking system would be reduced but the problems of the debtors would be addressed only very indirectly, if at all.

Let me say that I certainly favor increased bank capital to adequately cover country risk exposure—I championed the International Lending Supervision Act along with Senator Proxmire in 1983—but more capital must be only one part of a plan that provides better incentives for debtors and creditors to cooperate in resolving the lingering debt problem. I believe that such incentives can be provided through a regulatory carrot-and-stick approach.

Bank regulators must do a better job of differentiating country risk. As it stands, any country that represents a repayment risk is classified by the regulators as having Other Transfer Risk Problems. If interest payments are very late, the classification drops to substandard. In neither case does classification trigger action with regard to bank reserves or capital. Significant repayments risks of countries unable or unwilling to undertake policy reforms and moving toward insolvency need not be treated differently from countries pursuing reform with creditor support.

I would remedy this by requiring regulators to further differentiate the OTRP category of country risk between those countries successfully implementing reforms and self-help measures and working with their creditors, and those making no progress or regressing toward a substandard ranking whose debt represents a real and increasing risk.

For good performers and their creditors—the carrot. There would be no mandate to increase bank capital and regulators would provide the widest possible support for debt-equity conversions and efforts to provide a “breather” on debt service.

For poor performers and their banks, the “stick.” The regulators would treat country risk for this basket of countries as a high-risk category and ensure that bank capital and reserve positions reflect this higher risk. This would be above and beyond any special reserves for value impaired countries.

I know that some will say that debt-equity swaps and other measures that provide temporary relief are only a small part of the solution, not an answer. To that I repeat that there is no grand solution. Working at the margins is essential to success. Furthermore, an aggressive debt-equity program as in Chile, where 10 percent of debt is on the way to conversion over 2–3 years, would yield significant interest savings. If such a program were pursued by the 15 major debtors, interest savings over 3 years would be \$6–\$7 billion. That is substantial. It compares not unfavorably with Federal Reserve assessment of ambitious debt relief/debt-equity swap scenarios—by far the most substantial of several options yielded sav-

ings of \$18 billion. The policy commitments necessary to make a debt-equity program work would be exactly the confidence-restoring measures likely to restore flows of private capital from foreign and domestic sources.

STATEMENT OF BILL BRADLEY, U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman, for allowing me to come before the committee today and to testify. My purpose is really to talk about why the debt crisis continues and explore some possible framework for looking at it in the long term.

In February, Brazil suspended its payments for its foreign debt for a period of 3 months. I think there are 3 lessons in Brazil's action.

The first is that it is dangerously naive to deny the political nature of the debt issue. Brazil is a democracy. The new democracies of Latin America and the Philippines have replaced military governments, many of whom lived on a combination of irresponsible debt financing and inflation. The efforts of these young democracies to stay current on the debts of their predecessors have thrown many into recession and crippled their ability to combat poverty.

Democracies won't long tolerate leaders who choose debt payment over economic growth in fighting poverty. We are in the midst, I believe, of a worldwide referendum on the ability of democracy to cope with poverty, and I don't think we can afford to have it lose.

The second lesson is that emergency lending solves nothing. If I miss a payment on my credit card, what bank responds by increasing my credit line? It sounds preposterous, but that has been the preferred way to handle Third World loans. When an indebted developing country can't make a debt payment, banks provide fresh loans to cover the shortfall. The danger for debtors is that this scares their domestic investors, who invest abroad instead of at home. And once that happens, the country is left with higher debt, no new productive assets and the same old shortfall.

The danger for creditors is that emergency loans let banks treat bad loans as if they were good. Shareholders don't really know where they stand, and eventually banks' books lose touch with reality.

The third lesson is that some Latin American borrowers and larger banks have confused the roles of debtor and creditor in the debt workout process. I believe debtors should focus on attracting new loans. Creditors should focus on managing old loans. The 1980's are turning this upside down. Developing debtor countries are increasingly obsessed with managing old loans, rescheduling them, retiming them, repricing them or repudiating them.

International lenders, on the other hand, are increasingly obsessed with the question of new loans, offering them, withholding them, and conditioning them on the latest economic fashion. The problem is so basic that you almost miss it, but I think it has profound impact. Creditors have given up monitoring the use of funds and some debtors have given up making themselves creditworthy.

Somehow the goal of development has evaporated from debt management. Now this isn't true across-the-board. I mean, some debtors like Ecuador, Costa Rica and maybe more recently, Argentina, have made major economic reforms, but their creditors have given them no incentive to continue the reform. It appears banks respond to moratoria and threats, not reforms and commitments. So it is hardly surprising that debtors have started proposing moratoria instead of reforms.

Mr. Chairman, to straighten out creditors and debtors, American leadership is needed in four areas. First, American leadership is necessary to refocus Latin debtors and their bankers on the business of structural reform, economic renewal, long-term development, and the attack on poverty. But as long as the administration waits for problems to arise, coordinates emergency loans at the last minute and then imposes boilerplate conditions on debtors to legitimize bailouts, it will not provide leadership.

Second, Mr. Chairman, administration leadership can place the prime responsibility for debtor growth on the back of the indebted developing country leaders. Only Latin leaders can develop proposals for economic reform with any chance of success in Latin America's diverse complex political environment and only their success can bring back the voluntary movement of capital from the developed world to these countries.

Third, administration leadership can place the responsibility for debt management, as opposed to debtor growth, back on the shoulders of creditors. This responsibility is more urgent, if less far reaching, than the debtor's responsibility. But banks have failed to differentiate between their borrowers. No indebted developing country moved more dramatically last year to restore the conditions of stable economic progress than the Philippines, yet the country's lead creditor broke off negotiations at the slightest suggestion of interest rate relief.

No government has faced the political risks inherent in long-term structural reform as directly as Ecuador, yet the country's creditors refused to resolve its looming payments gap.

Meanwhile, the threat of a Mexican payment suspension was enough to put the Secretary of the Treasury and the Chairman of the Fed to work for 8 months coordinating new emergency financing for 1½ years of interest payments. A case-by-case approach to debt management is valid, but the failure of banks to differentiate between the policies of their borrowers has destroyed the borrowers' incentives to undertake politically risky reforms.

If banks do not respond to Argentina's reforms, for example, debtor initiatives to put their own houses in order, will disappear until long after payments have stopped.

And finally, Mr. Chairman, administration leadership can exploit a political opportunity. The year 1988 brings elections to half of the major Latin American debtors, and I don't think it is a coincidence that Mr. Gorbachev is seeking to tour the region a few months before the elections start, nor do I think it is a coincidence that in his address to the Party Congress, he devoted a paragraph or two to the Third World debt issue. By appearing to care more about bank profits than its workers or the poor in Latin America, the U.S. creates enormous political opportunities for parties sharply

opposed to democratic evolution and open economies. It is obvious banks have given up voluntary lending to the region, or they would not promote political solutions that threaten to close off its economy.

In the current crisis-charged atmosphere, I believe the administration should focus on indebted developing countries that have already enacted broad, and, at times, painful reforms, such as; countries like Costa Rica, Ecuador, and the Philippines. Otherwise, virtue has no reward. The alternative is a continuation of a cycle of moratoria which seems to coincide with Latin American election cycles. And, I might say, coincide ominously.

Neither the new democracies in the south, nor the careers of U.S. farmers and workers dependent on export growth can wait much longer. We have already lost over 1 million American jobs. The poor of Latin America, the Philippines, and elsewhere need a chance for a better life. Their leaders need encouragement to make tough economic decisions, and the U.S. economy needs their help and prosperity for mutual growth. Without that growth, democracy in Latin America will be endangered and we will risk a wave of illegal immigrants into the United States.

I have believed for a long while that debt and interest rate relief are the best ways to get growth started in debtor countries. Strong leadership from the executive branch could bring that about more effectively, but as long as the administration denies interest rate relief as a policy option, even though they have privately promoted marginal relief in the cases like Mexico, and as long as no effort is made to seize the strategic opportunity afforded by debt relief, a legislative solution must be developed.

And here, Mr. Chairman, I would say that your new proposal that you have discussed concerning a new facility may be the only way to provide some relief, particularly for the smaller, Latin American nations. An entity that buys LDC debt from banks at a discount and passes the savings on to the debtor can provide both debt and interest rate relief. It may also be the only way to give democracy a chance in Latin America and restore some of the million U.S. jobs lost to the Latin debt crisis already.

Mr. Chairman, I commend you for your effort, and I would like to work with you to try to bring it to fruition.

In closing, let me contrast the enormity of the debt dilemma with the small cost of resolving it. We are talking about turning around a crisis that has cost over 1 million American jobs in manufacturing and agriculture. At stake are the futures of young democracies throughout Latin America and the Pacific, job growth in the United States, the reversal of a U.S. trade deficit and the stability of our banking system. The cost is small. Creditors should provide relief before they are forced to accommodate default, and they should have the courage to offer relief to the debtors who deserve it most.

Most important, creditors and debtors must return to roles that preserve development as a goal of debt management. The accepted goal is economic growth. If emergency loans are a sound solution, the Mexican bailout should succeed, but I believe interest rate relief has a much greater potential. We should include substantial interest relief and debt relief in another country's package, let the

two compete, and then we will see which one produces more growth. We can't lose anything, I believe, by trying.

Mr. Chairman, finally, there is no such thing as international charity. I hope you will see that that is not what I am suggesting.

In international finance, there is only mutual growth or mutual contraction. To creditors, I say that you simply have to have the courage to differentiate among sovereign borrowers and have the foresight to offer relief that will encourage growth-oriented debtor reforms and strengthen democracy.

[The complete prepared statement of Senator Bill Bradley follows:]

Senator SARBANES. Thank you very much, Bill, for a very thoughtful statement.

I want to make just a couple of comments on it. First of all, I think that your point about the potential danger to the emerging democracies, particularly in Latin America, is very much on point. In fact, Bishop Weigand from the U.S. Conference of Catholic Bishops, yesterday made the point that in many instances, just as you have, they are struggling with this heavy debt burden that was assumed by military regimes which had preceded them and have, in effect, passed this problem on to them, and their own ability, therefore, to offer hope to their people, economically, has been limited or restrained by the financial legacy they have inherited from a previous irresponsible policy.

Interestingly enough, in my perception, at least, the democratic regimes have tried very hard to be more responsible than the more controlled or authoritarian regimes that preceded them, in terms of financial management, but it puts an enormous stress on them.

We had some testimony here yesterday, particularly from one representative of money center banks, that there is really not a crisis, it is a situation that we can work through. Brazil defaulted on its loans, in, I forget, 1922 or whenever it was.

Senator BRADLEY. About every 50 years.

Senator SARBANES. And so, you have all of these past examples and the world kept on going, and so forth and so on.

What is your reaction to that? I mean, how much of a crisis do you perceive?

Senator BRADLEY. Mr. Chairman, I remember in the summer of 1982, when I was visited by the head of a major money center bank that assured me during our conversation in my office that there was absolutely no problem with Mexico, that Mexico was moving ahead as it should, and that we would have no problem on their loan repayment. Of course, 2 months later, the crisis hit. Mexico almost defaulted and the debt crisis popped onto the front pages of our financial papers.

I think it is extremely serious. I think that you are playing with an unknown out there. There could very well come a time in the next year or year and a half, when all of the major debtors—Brazil, Argentina, Mexico, will, for the first time be similarly situated, such that one won't have a period of growth while the others are down. They could all be down simultaneously. It is very tempting in a Latin American political context to point to the amount of foreign debt and interest payments as being the cause of your inability to deliver a better standard of living. And I think that we are playing with political dynamite if we simply don't act to defuse this debt bomb right now. I think it is a natural banker's proclivity to assume that loans are going to be repaid even though we have a situation now where interest hasn't been paid on private debt in Venezuela since 1983. Since January 1985, Peru has only paid up to 10 percent of its export earnings on debt. Since January of this year, Ecuador hasn't paid and Brazil has announced a moratorium.

I mean, to me that sounds like a drumbeat that's trying to tell us something. As public policymakers I think we have a different responsibility than do bankers whose sole responsibility is to their shareholders.

Senator SARBANES. Senator Dixon.

Senator DIXON. Mr. Chairman. I have no questions of my distinguished colleague, but he has given us again one of his very thoughtful presentations, and I am grateful for it.

Senator SARBANES. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Well, let me say, Bill, I'm sorry I didn't hear your whole presentation. I agree with you that there is a problem. I agree that we have to act. I guess, as I look at the jurisdiction of this committee and the charge of this committee, our primary action's got to be to protect our domestic monetary system. After all, the banks made these loans. Their equity owners stand to gain or lose on the basis of whether they're good. What we want to do is to be sure that, first, a massive default does not spill into the domestic monetary system. And then I think, clearly, our second priority has got to be to try to come up with a way of dealing with the problem in such a way as to promote economic growth and democracy.

So I see those as our two objectives.

I guess, as I look at the problem—and I want to get your assessment of my view. As I look at the problem, the problem in Central and South America and the problem in the Third World, in general, I sort of liken it to a corporation that's trying to grow without having sufficient equity and trying to do it all with debt. I look at Mexico, which is the country I am most familiar with, because my State shares a common border with Mexico, and as I told the officials of the Mexican Government the last time I was in Mexico City—I was walking around shaking hands with people, which was kind of unusual for a politician there, and I explained to them I was doing it, because if they didn't get their act together, most of those people would be voting in my 1990 election. [Laughter.]

But as I look at their problems, a lot of their problem is trying to finance growth with debt rather than with equity.

And what is your reaction to a basic idea that we ought to move in a two-prong way, No. 1, begin to force the regulators to do what they all say we ought to do, but they don't do it, and that is, at least begin to try some general reserving against this debt to protect our monetary system? And No. 2, there is a need to do a combination of things. I am not claiming that it would do it all, but trying to look at some debt-equity swaps, trying to make as part of our negotiations with these Third World countries the requirement that they open up their markets to private investment.

What role do you see those things playing in this overall picture you're looking at?

Senator BRADLEY. On your last point, as a part of a total solution, I think debt-equity swaps make some sense, but I don't think that you should delude yourself as to the amount of difference they could make. If you look at the equity market in Mexico, it's about \$6 billion. In Brazil it's about \$45 billion.

I think that the debt is over \$100 billion in each place. So you might find some circumstances in which you could make a swap of debt for some equity in Mexico. I think that that is a healthy direction. I do not think, however, that it represents the solution, and I

think that it certainly can't move fast enough to defuse the political circumstance that I see developing in Mexico and in Latin America, generally.

It is very important to be able to get some new capital into these countries over the next 5 to 10 years. The most important criteria, the most important way that that can occur is if the debtor countries themselves put their own economic house in order, and I think that that's what you were saying. They should make their economies much more efficient. They should sell off some of the parastatal industries. They should open up their economy. I think that it should become a much more competitive economy, a much more open economy.

We have some responsibility though, and that responsibility is to come to the table with a little more than simply promise that we will get our banks to loan them enough new money to pay last year's interest. Because what is at stake in Latin America is what can we do to encourage Latin American political leaders to take the political risk that many of them have now. It's a new democracy. We need to encourage the Latin American leaders to take the political risk to get their economy in order. And that is why I have suggested that you have to be at the table with more than just a little new money. You have to be there with the possibility of some interest relief that gives them some cash flow flexibility, and some debt relief that gives them some sense that if they make the tough decisions to get their economy growing, they will have solved the problem for the long term.

And let me just give you one example. You mentioned Mexico. If you're a Mexican leader and you want to get your economy moving, you have to sell off some of the parastatal industries. The barnacles have built up on the political economy since the mid-1970's and you've got to open up your economy, move to GATT, et cetera.

In order to do that in Mexico, you have to be willing to take on the two most entrenched political constituencies. One is the entrenched industrial interests that have been living off government subsidies and sold off bad businesses to the government for the last 15 years. The second is the far left which doesn't want Mexico to be part of anything in the international system.

Senator GRAMM. I was wondering if you were going to say the unions. I noticed—

Senator BRADLEY. Well, some of the unions don't want to have the parastatal sold, but the point is that if you're going to make the economy move and make it more open, you are going to have to take on those two entrenched interests. A Mexican political leader will say, now what do I have to do? And if what we say is, well, we will give you enough new money to pay next year's interest, he's not going to proceed as vigorously as he should.

Senator GRAMM. Thank you, Mr. Chairman.

Senator SARBANES. Let me just make one final comment.

One of the reasons I put the facility idea forward is to try to create a link between the discount that banks would sustain on their debt and transmitting that to the debtor countries. I perceive a movement growing within the financial field. Now they want a stronger secondary market. Some banks are, in fact, getting rid of

their debt in the secondary market at discounted values. But the way the system works now, when they do that, the debtor country still is carrying at 100 percent, and whoever is taking it from the banks at the discounted value is then holding it, hoping that in one way or another, he's either going to get full value or something significantly above the discounted value that he paid for. And it seems to me, if the banks are moving in the direction of recognizing that perhaps they need to take a discount and that strengthening the reserve position is, to some extent, sustained in terms of the argument that it would then enable them to do that, set the reserves aside, it seems to me we have to go a step further and create some linkage that will result in the hit the banks take at being transferred in easing the debt overhang on the debtor countries. Otherwise, you get part of the picture, but you don't get the remaining part of the picture, and you don't improve the situation of the debtor countries and you don't lay out a plan. I think the leaders in those countries need to be able to lay out a plan to their people that say, well, if we take these tough measures, in effect, and everything works right, we can work our way out of this situation.

I don't see the current arrangements as doing that.

Senator BRADLEY. I agree with you, and I think that any facility should definitely pass along roughly the equivalent of the discounted value of the debt to the debtor. You know I think that in the long run that could make the banking system more stable here, because it would clear up the books. It would give the Latin American countries some room for growth, because it doesn't have as large a debt service burden. You could do it in such a way that the relief would come primarily in the form of interest rate relief. I think that would be a very important step forward.

Senator SARBANES. Well, thank you very much. We very much appreciate your testimony.

Senator BRADLEY. Thank you very much for your leadership and interest. I will take my graphs and go back to my office.

Senator SARBANES. OK. [Laughter.]

Next we will hear from a panel of some able and distinguished colleagues from the other side of the Hill. Three members of the House, all members of the House Banking Committee, Congressman LaFalce, Congressman Schumer, and Congressman Bruce Morrison.

Have you-all worked out an order amongst yourselves?

Mr. LaFALCE. Senior. [Laughter.]

Mr. MORRISON. The seniority system. We understand.

Mr. LaFALCE. Or alphabetical order. It's OK.

Mr. MORRISON. Good.

Mr. SCHUMER. Alphabetical's better.

Mr. LaFALCE. Either one.

Mr. SCHUMER. Starting backward.

Senator SARBANES. John, we would be happy to hear from you.

STATEMENT OF JOHN J. LaFALCE, U.S. REPRESENTATIVE IN CONGRESS FROM THE 32D DISTRICT OF THE STATE OF NEW YORK

Mr. LaFALCE. Thank you very much, Mr. Chairman. We all appreciate the opportunity to speak this morning concerning the urgent need to confront the reality of the Third World debt crisis.

I have a rather lengthy prepared statement. I would ask unanimous consent that it be included in the body of the record.

Senator SARBANES. The full statement will be so included.

Mr. LaFALCE. Thank you.

Mr. Chairman, last week the House Banking Committee approved legislation which addresses this very complex subject of Third World debt crisis. The House will consider that bill as part of the omnibus trade bill now scheduled for floor action on April 28. I sincerely hope the Senate will be able to include a similar proposal in its trade bill this year, so that the Congress can clearly express its position that the current administration policy is not adequately coming to grips with the dimensions of the problem.

I might also add too that I think that the gravamen of the House provision dealing with Third World debt is a legislative development of an idea that I read in an OpEd piece in the November 8 New York Times, written by one Paul Sarbanes. So I do believe, Mr. Chairman, that what the House has done might meet with your approval and approbation.

But before my colleagues and I detail the provisions of the House legislation, let me outline some of the history of the Third World debt crisis that has led members such as Walt Fauntroy, Bob Garcia, Chuck Schumer, and Bruce Morrison and others to insist that the administration needs to change its policy.

As we approach the fifth anniversary of this debt crisis, the issue is now moving again to the front pages, and we may be reaching a new breaking point. We have an increasing number of countries which are, in effect, declaring bankruptcy. We have a world financial and trading system, whose stability continues to be threatened and perhaps, most ominously, we have a pervading and dangerous sense of weariness with the whole situation.

Debtor countries and their creditors are increasingly locked into a series of protracted rescheduling negotiations, in which nothing is really resolved, but the mountain of debt is simply pushed forward into the future.

Unfortunately, the Reagan administration apparently doesn't share our sense of urgency. To the contrary, it insists that its current program calling for modest amounts of new lending by commercial banks, modest increases in lending by multilateral institutions and basic structural adjustment policy changes by debtor countries will do the trick.

Well, there are two things wrong with this analysis.

First, the program outlined by Secretary Baker in October 1985 is too little too late. Even on its own terms, the Baker plan proposals fall far short of its rhetorical goal of providing the resources necessary to spur growth and development for major debtor nations. Second, the program is failing to reach even its own modest goals.

Ten days ago I had the opportunity to attend the InterAmerican Development Bank meeting in Miami. I spoke with leading finance officials from Brazil, Mexico, Ecuador, and Costa Rica. At that same meeting, Secretary Baker gave a forceful speech outlining the success of current administration policy. It was a good effort, but very few people paid much attention, and for very good reason.

Simply put, commercial lenders don't want to lend to countries which are having great trouble in meeting current obligations. And the debtors, generally, don't want to borrow more money from the banks. I was told directly from representatives of Brazil, Ecuador, and Costa Rica, none of whom are currently making debt payments on schedule, that they don't want to increase their present debt, period.

I was also told by the Mexicans, that while their country is willing to take the new money offered as part of a massive rescheduling of debt, that effort will only provide a temporary band-aid for about maybe 18 months.

Indeed, as we are sitting here this morning, the Mexican loan package is still not officially signed, almost 1 year after negotiations began. Under such circumstances, the Mexico package may not characterize the beginning of the Baker plan, the Mexico package may characterize the demise of the Baker plan.

Now where do we go from here?

Well, clearly, the current situation wherein developing countries are providing a net transfer of approximately \$30 billion a year to their creditors is not sustainable, either economically or politically. We believe that instead of focusing primarily on new flows of capital, which obviously will not be forthcoming in adequate amounts any time in the near future, we must come to grips with the old debt. In short, our first principle is that the burden of existing debt must be reduced before significant new private capital flows will or should take place.

Our second principle is that the cost of dealing with the existing debt should be shared equitably amongst debtor countries, private creditors and the industrialized world.

Our third principle is that there is no one solution. There is no short-term fix. The fact is that no one program will get the job done. What is needed is the long-term commitment to use a number of mechanisms to remove the debt overhang. And that is the approach adopted in the House Banking Committee Third World debt legislation. As part of the total approach to this complex situation, our legislation basically proposes two things. First, our legislation calls upon U.S. regulatory authorities to provide maximum flexibility to commercial banks in negotiating any principal and or interest reduction with respect to the Third World loan.

Second, the legislation calls upon the Secretary of the Treasury to initiate negotiations for the establishment of an international debt management facility. This debt management facility would specifically be authorized to; (a) assist creditor banks in the voluntary disposition in the private sector of loans to heavily indebted sovereign powers; (b) encourage countries with strong capital surpluses to apply these surpluses to investments in heavily indebted countries; (c) purchase bank loans to debtor countries at a discount;

and (d) establish mechanisms for passing along the benefit of any such discount or other action of the facility to the debtor country, including mechanisms which would allow the facility to:

- (1) hold the discounted debt as the creditor of the borrowing nation;
- (2) arrange debt-for-equity swaps with private investors; and
- (3) transform fixed obligations into long-term securities which create a contingent claim on the export performance of the borrowing country.

Mr. Chairman, my time has expired.

This outlines very briefly what the House Banking Committee has done and why we've done it. I hope the Senate Banking Committee will now take up the idea, improve upon it, work together with us, but let's move forward to help defuse the Third World debt. I know my colleagues, Mr. Morrison and Mr. Schumer will go into much greater specificity with the details of the House Banking Committee bill that they coauthored.

[Complete statement of Congressman LaFalce follows:]

STATEMENT BY SENATOR BILL BRADLEY BEFORE
THE SENATE BANKING SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
April 2, 1987

Thank you, MR. CHAIRMAN, for allowing me to testify before this committee once again on the subject of Third World debt. My purpose is to explore why the debt crisis continues and to outline a framework for a lasting solution.

In February, Brazil suspended payments on its foreign debt for a period of three months.

There are three important lessons in Brazil's action. First, it is dangerously naive to deny the political nature of the debt issue. Brazil, now, is a democracy. The new democracies of Latin America and the Philippines have replaced military governments that lived on irresponsible debt financing and inflation. The efforts of these young democracies to stay current on the debts of their predecessors have thrown many into recession and crippled their ability to combat poverty. Democracies won't long tolerate leaders who choose debt payment over growth and fighting poverty. We are in the midst of a worldwide referendum on the ability of democracy to cope with poverty and we cannot allow it to lose.

The second lesson is that emergency lending solves nothing. If I miss a payment on my credit card, what bank responds by increasing my credit line? It sounds preposterous. But that has been the preferred way to handle Third World loans. When an indebted developing country can't make a debt payment, banks provide fresh loans to cover the shortfall. The danger for debtors is that this scares their domestic investors, who invest abroad instead of at home. The country is left with higher debt, no new productive assets, and the same old shortfall. The danger for creditors is that emergency loans let banks treat bad loans as if they were good. Shareholders don't really know where they stand. Eventually banks' books lose touch with reality.

The third lesson is that some Latin American borrowers and the larger banks have confused the roles of debtor and creditor in a debt work-out. Debtors should focus on attracting new loans; creditors should focus on managing old

loans. The 1980's are turning this upside down. Developing country debtors are increasingly obsessed with managing old loans: rescheduling them, retiming them, repricing them, or repudiating them. International lenders are increasingly obsessed with the question of new loans: offering them, withholding them, and conditioning them on the latest economic fashions. The problem is so basic you almost miss it. But its impact is profound. Creditors have given up monitoring the use of funds. And some debtors have given up making themselves creditworthy. Somehow the goal of development has evaporated from debt management.

This is not true across the board. Debtors such as Ecuador, Costa Rica, and more recently, Argentina have made major economic reforms, but their creditors have given them no incentive to continue reform. It appears banks respond to moratoria and threats, not reforms and commitments. It is hardly surprising that debtors have started proposing moratoria instead of reforms.

To straighten out creditors and debtors, American leadership is needed in four areas.

American leadership is necessary to refocus Latin debtors and their bankers on the business of structural reform, economic renewal, long-term development, and the attack on poverty. But as long as the Administration waits for problems to arise, coordinates emergency loans at the last minute, and then imposes boilerplate conditions on debtors to legitimize bail-outs, it can provide no leadership. Reform should be home grown or it will have no chance for success in the highly charged politics of indebted developing countries.

Administration leadership can place the prime responsibility for debtor growth back on the shoulders of indebted developing country leaders. Only Latin leaders can develop proposals for economic reform with any chance of success in Latin America's diverse, complex political environments. And only their success can bring back voluntary movement of capital from the developed world to their countries.

Administration leadership can place the responsibility for debt management back on the shoulders of creditors. This responsibility is more urgent, if less far-reaching, than debtors' responsibility. Banks have failed to differentiate between their borrowers. No indebted developing country moved more dramatically last year to restore the conditions for stable economic progress than the Philippines. Yet the country's lead creditor broke off negotiations at the slightest suggestion of interest relief. No government has faced the political risks inherent in long-term structural reform as directly as Ecuador. Yet the country's creditors refused to respond to its looming payments gap. The threat of a Mexican payment suspension, on the other hand, was enough to put the Secretary of Treasury and the Chairman of the U.S. Federal Reserve to work for eight months coordinating emergency financing for a year and a half of interest payments. A case by case approach to debt management is valid. But the failure of banks to differentiate between the policies of their borrowers has

destroyed borrowers' incentives to undertake politically risky reforms. If banks do not respond to Argentina's recent reforms, debtors' incentives to put their houses in order will disappear until long after payments have stopped.

Finally, Administration leadership can exploit a political opportunity. 1988 brings elections to half the major Latin American debtors. It is no coincidence that Gorbachev is seeking to tour the region a few months before the elections start. By appearing to care more about bank profits than its workers or the poor of Latin America, the U.S. creates enormous political opportunities for parties sharply opposed to democratic evolution and open economies. It is obvious banks have given up voluntary lending to the region or they would not flout political situations that threaten to close off its economy.

In the current crisis-charged atmosphere, I believe the Administration should focus on indebted developing countries that have already enacted broad and at times painful reforms -- countries like Costa Rica, Ecuador, and the Philippines. Otherwise virtue has no reward. The alternative is a continuation of the cycle of moratoria which seems to coincide with Latin American election cycles.

Neither the new democracies to the south nor the careers of U.S. farmers and workers dependent on export growth can wait much longer. We have already lost one million American jobs. The poor of Latin America, the Philippines and elsewhere need a chance for a better life. Their leaders need encouragement to take tough economic decisions. And the U.S. economy needs their health and prosperity for mutual growth. Without that growth democracy in Latin America will be endangered and we will risk a wave of illegal immigrants into the U.S. I have believed that debt and interest rate relief are the best ways to get growth started in debtor countries. Strong leadership from the Executive Branch could bring that about most effectively. But as long as the Administration denies interest relief as a policy option even though they have privately promoted marginal relief in cases like Mexico, and as long as no effort is made to seize the strategic opportunity afforded by debt relief, a legislative solution must be developed. Senator Sarbanes' legislative proposal for a new facility may be the only way to provide some relief, particularly for the smaller Latin American nations. An entity that buys LDC debt from banks at a discount and passes savings on to the debtor can provide both debt and interest rate relief. It may also be the only way to give democracy a chance in Latin America and restore some of the million U.S. jobs lost to the Latin debt crisis in the time frame needed. I commend him for his effort and hope to be of some help.

In closing, let me contrast the enormity of the debt dilemma with the small cost of resolving it. We are talking about turning around a crisis that has cost over one million U.S. jobs in manufacturing and agriculture. At stake are the futures of young democracies throughout Latin America and the Pacific, U.S. job growth, reversal of the U.S. trade deficit, and the stability of our banking system. The cost is small: creditors should provide relief before they are forced to accommodate default, and they should have the courage to

offer relief to the debtors who deserve it most. Most important, creditors and debtors must return to roles that preserve development as a goal of debt management.

The accepted goal is economic growth. If emergency loans are a sound solution, the Mexican bail-out should succeed. But I believe interest relief has much greater potential. We should include substantial interest relief and debt relief in another country's package. Then let's see which one produces more growth. We can't lose anything by trying.

There is no such thing as international charity. I hope you'll see that that is not what I am proposing. In international finance, there is only mutual growth or mutual contraction. To creditors I say you must have the courage to differentiate among sovereign borrowers, and having the foresight to offer relief that will encourage growth-oriented debtor reforms, and strengthen democracy.

STATEMENT
OF
REPRESENTATIVE JOHN J. LaFALCKE

BEFORE THE

SENATE BANKING COMMITTEE
SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND MONETARY POLICY

APRIL 2, 1987

Mr. Chairman -- I very much appreciate the opportunity to speak this morning concerning the urgent need to confront the reality of the Third World Debt crisis. Last week the House Banking Committee approved legislation which addresses this issue. The House will consider that bill as part of the Omnibus Trade Bill now scheduled for floor action on April 28. I hope that the Senate will be able to include a similar proposal in its trade bill this year so that the Congress can clearly express its position that current Administration policy is not adequately coming to grips with the dimensions of the problem.

But before my colleagues and I detail the provisions of the House legislation, let me outline some of the history of the Third World Debt crisis which has led Members of the House such as Walter Fauntroy, Robert Garcia, Chuck Schumer, Bruce Morrison, myself and others to insist that the Administration needs to change its policy.

BACKGROUND

For almost five years, the term "crisis" has been applied to the issue of Third World Debt. This debt was contracted principally during the 1970's when real interest rates were low; when commodity prices were rising; and when American foreign policy encouraged developing countries to borrow foreign capital to supplement domestic investment and help finance the purchase of capital goods and energy imports.

At the time, this extensive borrowing was considered sound financial practice. In general, Latin American countries borrowed heavily from commercial banks; African countries borrowed from official sources; and Asian countries blended the two. Beginning in 1980, however, world-wide recession, skyrocketing interest rates, an appreciating American dollar, and declining commodity prices all came together to severely curtail the ability of borrowers to service their international debt.

A full-blown crisis emerged when Mexico announced in the summer of 1982 that it was unable to meet its debt service payments. But the problem went far beyond Mexico. For example, Latin American debtors as a group owed \$378 billion, with annual interest payments totalling \$38.5 billion. Latin America's 1982 trade surplus, however, was only \$8.5 billion, or roughly \$30 billion less than what was needed to service its external debt.

By the end of 1982 it was equally apparent that the deteriorating financial situation was not only a crisis for the debtor nations, but also for their creditors -- and particularly for several American money-center banks which found themselves dangerously exposed with inadequate capital to cover potential losses. For example, Latin American loans from the nine largest

Senator SARBANES. Thank you very much, Congressman LaFalce. Congressman Morrison.

STATEMENT OF BRUCE A. MORRISON, U.S. REPRESENTATIVE IN CONGRESS FROM THE THIRD DISTRICT OF THE STATE OF CONNECTICUT

Mr. MORRISON. Thank you, Mr. Chairman, and first let me thank you for permitting us the opportunity to come before your subcommittee this morning and to outline some of our views and to report on the work that has gone on in the House Banking Committee, I think, of which all three of us are proud of the fact that we've made a significant step forward in terms of legislative action, which Mr. LaFalce, I think, has quite adequately described, is more than overdue.

Just briefly, to say what's at stake, I think, as Senator Bradley also did, what's at stake in this crisis is, first of all, the domestic banking system, despite the reduction in the level of risk we're talking about, the major banks with 191 percent of the capital at risk in the 15 major debtor countries. That is still a crisis, in terms of what would happen in the case of a major default or a long-term moratorium. Beyond that, our own loss of trade opportunity and trading markets because of the austerity measures that have been required over the last 5 or 6 years in these debtor countries responding to trying to get foreign exchange to pay debts that they have accrued in the past.

Our growth has been sacrificed in this crisis.

The Third World growth that has been lost over the last 10 years is quite significant. We have countries that are essentially back where they were 10 years ago, in terms of their growth progress, as the result of the austerity measures that the debt load has imposed upon them. This is really a lose-lose proposition for the American economy and the economy of the Third World. Hardly what we'd have in mind.

Finally, I think, as Senator Bradley so eloquently pointed out, democracy is at stake in this situation. We know all too well in this Congress the difficulty of a democracy coming to grips with difficult economic choices. We speak glibly of the actions that must be taken by debtor countries in order to reform their economies, but democracies must respond to the needs and desires of their people and the ability to do that does not exist in the world of merely paying for the past excesses of dictatorships and imposing upon people long-term losses in their standard of living without any hope for real future prosperity.

If we want to see democracy flourish in Latin America and elsewhere, we are going to have to be more creative than we have been.

I want to speak just briefly about some of the details of the debt management facility as I and others have conceived of it and express why I think it is one piece of the solution to this problem.

It is a response that hopes to turn this lose-lose proposition of loss of growth opportunities in the Third World and loss of trading opportunities in the developed world into a win-win result, in which we can restore growth, real growth, long-term growth in the

developed world and also restore markets for the benefit of our own producers here in the United States

The risk to the banking system cannot be dealt with unless we can deconcentrate that risk and reduce it. We are not going to grow out of it quickly enough. That's been demonstrated by the last 6 years.

The purpose of the facility is to find a mechanism to expand and nurture a secondary market into which banks—the commercial banks, can be selling at a discount that reflects, not some arbitrary legislative judgment but a market judgment of the true value of these loans.

Beyond that, we propose the consideration of regulatory reform that will allow the losses that banks sustain in this process to be managed over a period of time so that no institution takes an undue hit to capital in any one year. This would be beneficial in terms of the stability of our banking system.

What is the next step is that the facility that would be purchasing these loans at discount would engage in a series of actions to turn a Nation that cannot manage its current debt service into one that can, by reducing that debt service burden and by also through conditionality in negotiation improve the economic performance of the country, not by the threat of default, not by the threat of no new money, but by the promise that there is real reduction in obligation and burden that can come through a combination of actions.

Why is that true? Well, first of all, the possibility that this facility will be able to sell repackaged obligations out into a secondary market will be greatly enhanced to the extent that the country can do certain things that support those securities as they are repackaged. That has to do with buying back some of those securities to reduce the obligation beyond what has already been reduced by the discount, which is to be passed through.

It means debt-equity swaps, and opportunity to once again reduce debt servicing loads by looking for equity investment opportunities that can be swapped. It means collateralization, looking for collateral that does exist in the economy that can be pledged to support these loans, which will make the interest rate obligations that will go with them lower when they are resold in the secondary market.

It means a securitization that looks at other options beyond the annual debt service that one has to pay to a bank to various arrangements by which the immediate debt service might be little or none, in exchange for greater obligations down the road that a country would be more able to meet after a period of growth.

Overall, this is a mechanism that gives a flexibility that does not exist in the current system. It does it in a way that does take a hit on the banks, but not one that does anything more than reflect the current market hit that exists out there and does it in a way that protects the banking system by looking to managed regulatory reforms, so those losses will not be unmanageable.

I think it is an opportunity to move in a new direction. It by itself is probably not the whole answer, but it is part of the answer, and I hope that by legislating some authority and obligation on the Treasury to move in this direction, we can open a new window of

opportunity to solve a problem that I think everyone is in agreement needs a solution beyond what is being done today.

[Complete statement of Congressman Morrison follows:]

U.S. banks totalled 175 per cent of their combined capital in 1982. Under such circumstances, any significant default on outstanding debt by Latin American countries would have constituted a serious threat to the U. S. banking system -- and the American economy. In short, debtor and creditor nations alike were linked together in crisis.

Three things were done in response. First, new private lending to most developing countries dried up almost immediately. Second, the Reagan Administration reversed its previous policy, and became actively engaged -- with the Federal Reserve Board -- in leading a coordinated international effort to help manage the situation. Third, on a case-by-case basis, debtor countries received short-term balance of payments financing from the International Monetary Fund (IMF), and commercial banks were strongly encouraged to reschedule outstanding loans. In return, debtor countries agreed to undertake domestic adjustment programs designed to reduce inflation and imports, while promoting exports to earn foreign exchange to meet interest payments.

I welcomed the Administration's change of policy; I supported the efforts of the Federal Reserve Board; and I voted for a substantial increase in IMF resources. Everyone involved held their collective breath, and hoped that within a few years, developing countries would regain their creditworthiness; the risk to the world financial system would be reduced; capital would again flow "South"; and economic growth could return.

Unfortunately, it did not happen. After some promising signals, and a lot of wishful thinking, the situation has not improved meaningfully -- indeed, living standards in several of debtor countries have fallen precipitously, resulting in political instability in a number of newly emerging democracies.

Herculean efforts were made by a number of debtor countries to earn foreign exchange. For example, Latin American imports were slashed by 40 per cent; while the volume of Latin exports doubled. But commodity prices continued to fall, and trade surpluses still failed to match interest payments. Domestic savings were tapped to pay external debt, resulting in a 35 per cent drop in domestic investment. Yet, international commercial loan windows still remained essentially shut tight to new lending. From 1971 to 1981, there was a net transfer of capital resources into Latin America of almost \$100 billion. Since 1982, that net transfer has been totally obliterated, with a net drain of capital averaging about \$30 billion annually.

By the middle of 1985, it was apparent that the short-term plan was neither working financially nor was it sustainable politically in the debtor countries. Additionally, it was becoming clear that the impact of the debt burden now extended well beyond the debtor countries and their private creditors. The problem was "moving North" to American manufacturers and farmers who saw their Latin

American markets closed and new international competition arise. In October of 1985, Secretary of the Treasury, James Baker unveiled a "new plan" focused on growth and additional lending. Specifically, over a three year period, commercial banks would lend \$20 billion in new money, the World Bank would increase lending by \$9 billion, and debtor nations would continue making structural economic adjustments.

Once again, I applauded the Administration's recognition of reality - however delayed in coming. The initial international reaction to the Baker Plan was favorable, but it soon became apparent that there was little beyond the rhetoric of the initial speech. Even on its own terms, the proposed new lending program of the Baker Plan would fall far short of promoting growth in the fifteen major debtor countries that were targeted for assistance. But the program has failed to reach even its own modest goals.

The essence of the Baker Plan is to induce private banks to increase their exposure to heavily indebted countries. This program was tested in mid-1986 with protracted and difficult negotiations to provide additional resources to Mexico. Even with extraordinary pressure brought to bear by the Reagan Administration and the Federal Reserve Board, and the "carrot" of substantial new official lending, American commercial banks resisted throwing "good money after bad." Finally, agreement was reached in principle, but it has taken an additional six months to line up the \$7 billion in private lending incorporated into the Mexico package. The most recent pronouncement was that the final agreement would be officially signed on March 20, with close to 75 smaller banks -- mostly American -- still refusing to participate. However, even though a signing ceremony did actually take place on March 20, the fact of the matter is that the Mexico package is still incomplete some two weeks later. Under such circumstances, I believe that the Mexico package may characterize not the beginning of the Baker Plan, but its demise.

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As we approach the official fifth anniversary of the debt crisis, the issue is now moving again to the front pages; and we may be reaching a new breaking point.

After five years, most American bankers are simply refusing to add to an already unserviceable mountain of debt -- not an irrational position. After five years of austerity, debtor countries are simply refusing to continue to have their economies -- and political stability -- held hostage to the inexorable demands of debt servicing when there is apparently little chance that new financing will be forthcoming. After five years, official sources of lending are actually contracting. American bilateral programs are being reduced due to budget constraints, while multilateral institutions are actually providing a "negative cash flow" to many debtors. For example, IMF reflows during 1986 exceeded disbursements by about \$1 billion, while the World Bank may see its reflows exceed new lending for the next few years unless

disbursements on existing loan commitments can be accelerated. And after five years, the U. S. trade deficit has grown from almost \$40 billion in 1982 to \$170 billion in 1986, with the rapid deterioration of our terms of trade with third world debtors contributing significantly to these problems.

As we approach the fifth anniversary of the debt crisis, we have an increasing number of countries which are, in effect, declaring bankruptcy; we have an Administration policy which is not coming to grips with this problem; we have a world financial and trading system whose stability continues to be threatened; and perhaps most ominously, we have a pervading and dangerous sense of weariness with the whole situation. Debtor countries and their creditors are increasingly locked into a series of protracted rescheduling negotiations in which nothing is really resolved, but the mountain of debt is simply pushed forward into the future.

At this point, instead of throwing up our hands, and hoping that the whole intractable problem will somehow disappear, we need to step back, take a fresh look, and develop a new approach.

THE BURDEN OF EXISTING DEBT MUST BE REDUCED BEFORE NEW PRIVATE CAPITAL FLOWS WILL OR SHOULD TAKE PLACE

Everyone understands that debtor countries need additional external finance to foster economic growth, improve their living standards, and maintain political stability. Everyone also understands that the world economy needs growth in the developing world in order to provide additional markets for goods and services from industrialized countries. However, growth of imports in developing countries must be financed by capital flows from abroad; and that is simply not happening.

But it is not realistic to expect that it will happen until and unless there is a concerted and effective program to reduce the burden of existing debt. Commercial banks are not making new voluntary loans because they understand better than anyone that developing countries are already overextended financially. The goal of any effort to reduce the existing debt burden should be to return debtor countries to private creditworthiness as soon as possible. That does not mean reducing the debt to zero, but rather to make interest payment to export ratios much more manageable than at present. It is not an impossible task.

THE COSTS OF DEALING WITH EXISTING DEBT BURDENS SHOULD BE SHARED
EQUITABLY AMONG PRIVATE CREDITORS, DEBTOR COUNTRIES, AND THE
INDUSTRIALIZED WORLD

Up to this point, most of the burden of dealing with the debt crisis has been borne by the debtor countries -- as it should be. They contracted for the loans, and they are responsible for the repayment. Over the long term, it is in their best interests to do whatever is necessary to meet those obligations, including difficult adjustments in economic policies.

But the leaders of developing countries will understandably draw the line on adjustment programs which would destabilize their societies. Additionally, creditors need to recognize that meaningful structural adjustment policies may take decades before positive results are realized. A proper balance must be found between the desires of creditors for full payment on schedule, and the reality that debtors cannot always meet that schedule. Historically, we learned that lesson after World War I, when Germany was forced to pay reparations; after World War II, we saw the wisdom of the Marshall Plan. Now, in dealing with Third World Debt, we need similar vision, and instinct.

This is not to imply that somehow the commercial bankers are the villains in this scenario. I do not think that the private banking system deserves to be criticized for having made Third World loans during the 1970's; and I certainly want to promote public policies which will lead to a resumption of commercial lending to developing countries in the 1990's. The position of the major banks is rather simple, and direct -- they made the loans at market rates, and they expect to be repaid. Period. But sometimes, risk analysis is faulty; and loans go bad. Sometimes, payments must not only be stretched out; but profits have to suffer. And sometimes, debtors default when they simply can not make the payments.

That is the nature of the banking business, and I believe that the private creditors -- after five years -- simply must show a greater willingness to make the adjustments necessary to put this crisis behind us, rather than to prolong it indefinitely for the sake of continued short-term profits.

Finally, industrialized countries need to do more, both bilaterally, and through multilateral institutions. Over the past five years, Third World exports have risen principally because the U. S. has kept its markets open to such goods. Japan, Germany and the rest of the OECD countries have not done nearly enough to help Third World countries meet their export requirements; and now that the American trade deficit has reached unsustainable levels, Germany and Japan will have to pick up the slack.

Moreover, the role of the World Bank and other multilateral institutions needs to be substantially expanded. However, because of budgetary constraints, it is clear that any significant increase in direct lending programs is politically unfeasible at the present time. Creative mechanisms, therefore, must be found to do more with existing resources in order to allow the multilateral institutions

to play a positive intermediary role between debtor countries and their creditors, and to facilitate the transformation of fixed debt obligations into equity interests, or long-term securities.

THERE IS NO ONE SOLUTION -- THERE IS NO SHORT-TERM FIX

In 1982, we hoped the short term IMF lending program would do the job - it did not. By 1985 we hoped a new lending program with emphasis on growth would work - it has not. The Institute for International Economics has suggested a massive new World Bank lending program - it's a good idea in theory, but not politically feasible. Others have focused exclusively on debt-for-equity swaps, or the repayment of some portion of interest in local currencies. Again, these are good ideas; but there are severe limits on the amount of debt a country can convert to equity, or the amount of local currencies that can be profitably used. Other proposals call for short-term moratoriums on official debt repayments or the unilateral write down of principal or interest by the banks. The fact is that no one program will get the job done; what is needed is the long-term commitment to use a number of mechanisms to remove the debt overhang.

The legislation which the House Banking Committee has approved is designed to deal with this problem on a number of fronts, and to stick with the problem until it becomes more manageable.

REGULATORY PRACTICES

First, the Banking Committee legislation calls upon the U.S. bank regulatory authorities to provide maximum flexibility to commercial banks in negotiating any principal and/or interest reductions with respect to Third World loans, including the application of "FASB 15" standards of accounting to restructured loans; requires the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation to undertake studies to identify current regulatory or statutory obstacles, if any, to commercial banks negotiating interest reductions, or selling their Third World loans at a discount; and mandates a comparative analysis of American regulatory practices and those of other OECD countries in dealing with loan loss reserves and capital adequacy standards regarding high-risk loans to foreign borrowers.

ESTABLISHMENT OF AN INTERNATIONAL DEBT MANAGEMENT AUTHORITY

In the 1970's, the IMF sponsored a special facility to help developing countries deal with problems associated with the first oil shock. It is now time for a multilateral special facility to be created to deal with Third World Debt over the long term. The House Banking Committee legislation proposes that the Secretary of the Treasury should immediately open negotiations for the creation of a special debt adjustment facility which would be specifically authorized to:

First, assist creditor banks in the voluntary disposition, in the private sector, of loans to heavily indebted sovereign borrowers;

Second, encourage countries with strong capital surpluses to apply these surpluses to investments in heavily indebted countries;

Third, purchase bank loans to debtor countries at a discount; and

Fourth, establish mechanisms for passing along the benefit of any such discount or other action of the facility to the debtor country, including mechanisms which would allow the facility to--

- hold the discounted debt as the creditor of the borrowing nation;
- arrange debt-for-equity swaps with private investors; and
- transform fixed obligations into long-term securities which create a contingent claim on the export performance of the borrowing country.

The cornerstone of opposition to any proposals for debt relief, be it interest concessions or a discounting of principal, is that accepting such "damage" to existing assets might prevent commercial banks from extending credit on a voluntary basis in the future.

Responding to this concern, I simply ask one question: "what voluntary lending?" Since 1982, private banks have sought to reduce rather than increase their exposure to problem debtors, and all the net new lending which has taken place has been "involuntary."

Finally, I want to make it clear that while Third World countries need help in meeting their responsibilities; the debtor countries themselves have to confront the issues that have turned the repayment of their loans into a crisis. First and foremost among those responsibilities is the necessity to adopt policies which will stem the flight of capital, and lead to its eventual return. It is unreasonable to expect foreign banks to start to lend again to debtor countries, if their own nationals largely seek investments elsewhere.

In this regard, I want to reiterate again that the proposed new debt management facility would only be available to those countries whose policies were conducive to their regaining creditworthiness with private lenders. This special facility would in no way provide "an easy way out," or reward debtor countries which had consistently mismanaged their domestic economic affairs.

Mr. Chairman, this outlines what the House Banking Committee has done, and why we have done it. I hope that the Senate Banking Committee will now take up the idea -- improve upon -- and working together, we can move forward to help to defuse the Third World Debt bomb.

REP. BRUCE MORRISON

STATEMENT
before the
SENATE BANKING SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

April 2, 1987

Mr. Chairman, I want to commend you and your Senate colleagues for your leadership in addressing the crucial issue of Third World debt. As our testimony will indicate, those of us on the House Banking Committee who have devoted our energies to this problem have become convinced that action on Third World debt is urgent. As our passage of a bill in the committee last week demonstrated, we have also become persuaded that creative steps to defuse the debt crisis are possible.

Before going into detail about the key debt provisions approved by the House Banking Committee last Wednesday, let me say why I believe this issue is so vital to the United States.

The Third World debt crisis affects three major areas of concern we have as a nation: trade, growth and democracy. The U.S. cannot serve its own interests in these three areas unless and until we act decisively to deal with the Third World debt crisis.

You, Mr. Chairman, along with Senator Bradley, deserve special praise for the work you have done in educating the public about the link between trade and debt. As is now widely understood, the actions taken by the debtor countries since 1982 to enable them to pay their debts have had twin negative results for the United States: they have been forced to emphasize exports, particularly to the United States, in order to earn adequate foreign exchange; and they have been forced to limit their imports from our farmers and manufacturers as they took the austerity medicine prescribed for them.

The consequence for us is obvious. The shift in trade with Latin American debtor nations has been a very significant factor in the emergence of the intolerable U.S. trade deficit which we are now struggling to reduce. What that means to our constituents, of course, is simple and painful--lost jobs.

At the same time, this shift in trade has not been a victory for these debtor nations at our expense. Far from it. This has been a classic "lose-lose" experience. Their reduction of imports from us, the constant efforts at austerity and export promotion to service debt obligations, all have cost them dearly. In testimony heard repeatedly on the House side for over two years, we have been told that Latin America has lost a decade of potential growth. Living standards have been drastically depressed by the weight of these debt obligations--in many cases reverting to the standards of ten years ago.

Their economic growth has thus been stymied just as ours has been curtailed. This intensely negative development in trade and economic growth touches directly on the third vital interest of the United States: democracy.

I hope and believe that a critical component of U.S. policy in international economic matters is fostering and supporting genuinely democratic governments that respect the human rights of their citizens. As we in the Congress surely can understand, it is hard in a democracy to pursue the politics of austerity. The courage shown by many developing nation leaders in trying to meet their international debt obligations has been remarkable.

We here in the United States have an interest in making the pain less, not more, for those democratic governments. If they fail because of the antipathy inevitably generated by austerity policies and falling standards of living, then we fail. And we shall surely pay for that failure in ways that are extremely costly in human and economic terms if the democracies of Latin America give way to the demagogues of left and right who respect neither democracy nor human rights.

Having stated what I view as the U.S. interest in this issue, let me review what the Banking Committee has approved. Attached to my statement is a synopsis of the provisions of the bill we approved last week for inclusion in the trade bill to go to the House floor later this month. The provision which I personally view as the most promising is the clear mandate for multilateral negotiations to create a new International Debt Management Authority.

The urgent need for a new institution to deal on a comprehensive basis with debt is now clear. A new entity with multilateral support and a clear mandate would be able to provide the creative financial leadership which is required.

The authority we are proposing would be empowered to take the sovereign debt off the books of the commercial banks by acquiring the debts at a discount. The banks would be required to accept the losses on these loans that would be dictated by the free market. In order to make such losses manageable, the Committee has signaled its willingness to look at recommendations for regulatory relief, such as deferred loan loss recognition, to keep such losses from threatening the soundness of individual banks or the safety of our overall system.

The debt management authority would then take these debts and work together with the debtor nation, as a bankruptcy court might with a debtor company, to restructure its debt. The authority could act as the intermediary and facilitator of a wide range of creative financial approaches that are already being tried on a limited basis in the marketplace. Debt/equity swaps, long-term securitization, collateralization and similar techniques could be employed.

In the end, this restructured debt could be resold into the

secondary markets to new investors worldwide. The aim should be to tap the world capital markets to provide these countries with the funds they need at a current price they can afford.

In plain language, we are talking about moving this debt off the books of U.S. banks where it is dangerously concentrated and into the hands of a broader spectrum of investors, including Japanese and German investors who have ample capital liquidity.

The proposed debt management authority could thus perform a major role in achieving our three objectives. The resulting reduction in the debtor nations' debt servicing burden would permit a return to a sensible trade regime. It would no longer be necessary to flood our markets with their products, and they would again be able to open their own markets and pay for our products.

Their restructured debt portfolios would make them once again creditworthy. One of the important arguments we have heard against any form of debt authority or debt "relief" is that it might lessen the willingness of banks to lend new capital. That argument is blind to the reality that banks are simply refusing to lend new money now, other than funds for servicing of existing debt--for quite obvious reasons. The likelihood is that after this restructuring the developing nations will emerge as considerably better credit risks and will in fact attract new capital as needed.

Moreover, easing the debt servicing crunch will allow them to keep more of the foreign exchange they earn in trade, thereby generating capital themselves which they can use for economic growth and development. The resumption of sustained economic growth is clearly the goal which everyone now addressing this issue shares, and the authority could be a major factor in its achievement.

Finally, the return to a sensible trade regime and economic growth is our best hope for preserving democracy in these debtor nations. If the leaders of these democratic debtor nations can once again offer their people the prospect of a better, more prosperous life, then democracy will work and survive. If the people do not perceive such benefits from their democratic governments, then democracy itself will be brought into question.

Mr. Chairman, I believe the House Banking Committee proposal for a new debt management facility is workable and wise. I also know that your committee will work diligently and will produce a wise approach. I and my colleagues look forward to being of whatever assistance we can as you continue your work. And we look forward to a conference on the trade bill where together we can craft a major new initiative to address this vital problem of Third World debt.

Bruce A. Morrison

Member of Congress
Third District, Connecticut

SUMMARY
HOUSE BANKING COMMITTEE
THIRD WORLD DEBT LEGISLATION

On March 25, the House Banking Committee approved its portion of the omnibus trade bill to be considered by the full House in late April. The Banking Committee title of the trade bill contains provisions to reduce the volatility of exchange rates, to increase American competitiveness, and to respond to the Third World debt crisis.

Major Banking Committee provisions on Third World debt:

*A required study of the potential use of Special Drawing Rights (SDR's) to provide the poorest of the poor nations with needed liquidity to manage their debt burdens.

*A statement of Congressional intent that bank regulators should provide maximum flexibility to encourage negotiated reductions in principal and interest obligations of developing nation debtors.

*A required study of existing regulatory impediments to negotiated reductions in sovereign debtor obligations, of current regulatory obstacles to the sale of sovereign debt at a discount into the secondary market, and of changes that may be needed in current reserve requirements related to international lending.

*A statement that banks participating in debt reschedulings should be aware of options to participate in syndicated reschedulings in ways other than the provision of new funds, including interest and principal writedowns and debt/equity swaps.

*A required study of the past profitability of commercial bank lending by the major money center banks to sovereign nations.

*A mandate for the Secretary of Treasury to initiate negotiations with other nations to create a new International Debt Management Authority. This Authority would be a financial intermediary empowered to acquire commercially-held sovereign debt and negotiate directly with the debtor nation to repackage, securitize, and restructure the debtor nation's debt portfolio. A study is required of possible means of capitalizing this new debt facility.

Additional provisions related to debt include a call for U.S. leadership within the World Bank and the IMF to find solutions for the problem of capital flight, a study of the impact of past IMF austerity policies on debtor nations, a study of means of mobilizing greater private capital for developing nations, and a provision for U.S. participation in the recently negotiated Multilateral Investment Guarantee Agency (MIGA).

Senator SARBANES. Thank you very much. Congressman Schumer.

STATEMENT OF CHARLES E. SCHUMER, U.S. REPRESENTATIVE IN CONGRESS FROM THE 10TH DISTRICT OF THE STATE OF NY

Mr. SCHUMER. Thank you very much, Mr. Chairman, and again let me thank the members of this committee for inviting us here and also my colleagues, Mr. LaFalce and Morrison, for inviting me. I ask that my written statement be included in the record.

I would like to talk about a separate part of the House plan. I have not been involved terribly much in the facility aspect of the plan. That has been Mr. LaFalce and Mr. Morrison. I have successfully added to the House bill the options plan. And instead of going into the detail as to the whole problem, I think we all agree on that. Let me tell you why I gravitated toward this option plan, which I believe is certainly not in conflict with and in all likelihood complementary or go side by side with the kind of relief facility that my colleagues spoke about and that you have written about, Mr. Chairman.

I have been involved in this Third World debt issue for 3 or 4 years, and you feel like you are banging your head against the wall, because it is pretty obvious that the present situation, lending new money to repay old money does no one any good. It certainly doesn't do the Third World countries very much good. It doesn't do the banks very much good. Their stock prices, despite the fact that they are making more money from the recycling of this debt are low, so the market isn't putting much credibility in the solution, and it doesn't do the geopolitico interests, as well as the economic interests of the United States very much good, as Senator Bradley has so well and eloquently outlined in previous speeches and here today.

So then the question is, what do we do about it? And to simply propose solutions that mandate change just won't happen. That is the bottom line. If I was the czar of Third World debt, I would draw up a solution that would be quite different than what I put in the bill. But you can't mandate. You need to make some framework. You need the agreement of debtor countries, of banks and of governments and not just the U.S. government and not just U.S. banks, but all banks.

And that is—I think the facility is an excellent idea, but it does pose a conundrum, if Secretary Baker chooses to only halfheartedly negotiate such a facility, because he has stated he is opposed to it, where are we? He stated Congress' view, which I think is helpful, but we haven't achieved our primary goal of getting debt relief to those Third World countries and getting stability to the banks.

The options plan proposes to nibble around at the edges, not much more, but I think in a way that's truly significant, because what it would do is, it would capitalize on the fact that not all banks wish to continue to provide new money to repay old debt. Certainly the money center banks do and with good reason. I think the aphorism, you owe \$1 million to the bank, you're in trouble. You owe \$1 billion to the bank, they're in trouble, sort of dictates what has happened. The banks cannot afford—big banks with such

large exposures can't afford write downs right now, whether it be by facility or anything else. They are afraid of them.

But there are many littler banks, regional banks and many foreign banks that want a different method of debt relief, that might want debt equity swaps. They all want that, but that might also want interest rate relief in debt write down. In fact, as I am informed, a gentleman from a regional bank, Mr. Coltman of the Philadelphia National Bank, suggested that options would be a good idea, as far as his bank was concerned.

What the options plan simply says, Mr. Chairman, is that after the negotiation occurred between the IMF and the lead bank, Citibank, Manufacturers Hanover, depending on the country, after that negotiation occurs in Brazil, if that is the country involved, says, OK, we will do A, B, C in our country, and you will lend us new money, that the Treasury must publish a table of equivalences, so that it says, instead of putting in a new dollar of debt relief, any bank could provide .00—and I am just choosing numbers, a certain reduction in the interest rate they charge that country on their overall debt or a certain percentage of write down on the debt.

What that would do, Mr. Chairman, is a couple of things.

First, it would allow a way out for those regional and, incidentally, foreign banks—the UBS Bank in Switzerland, Mr. Leutoff, at a conference that I attended that was put together by Mr. Bradley and Mr. Kemp, wanted to do this. It would allow those banks to provide a new way of debt relief. Would it be 50 percent of the banks or 70 percent of the banks? No. The Citibanks and the Manny Hannys and the Banks of America would still be doing the same thing they wanted to do. But maybe 10 or 20 percent of the debt would be treated in a different way, and what would that do? It would provide some debt relief. It would certainly strengthen that secondary market that the facility would rely on, and it would furthermore show the Secretary of the Treasury, the IMF, money center banks, that this method of relief could, indeed, work, and my belief is that if this options plan—and I will try to speed it along, because I know the committee didn't want us to take too much time here, but it is my belief that if this options plan were passed by the Congress, first, it would be implemented immediately. You wouldn't need Secretary Baker to negotiate. Second, it would strengthen that secondary mortgage market and might, indeed, provide, not the ultimate solution, which it clearly is not, but a pathway that would allow that ultimate solution, be it debt facility or some other, to ultimately occur.

So I would ask the committee, in all deference, to consider this option plan, in addition to, not in replacement of, the facility that I know the chairman had advocated.

I thank the committee.

[Statement of Congressman Schmuer and the Schumer options plan follow:]

The International Debt Management Authority proposed in the Banking Committee title arises from legislation previously introduced by Reps. Bruce Morrison and Sander Levin (HR 1453) and Rep. John LaFalce (HR 1423) and the work of Chairman Walter Fauntroy of the Subcommittee on International Development Institutions.

The core concept of this proposal is that the worsening debt situation requires an official multilateral manager with powers to achieve two key goals: the deconcentration of sovereign debt held by commercial banks that now jeopardizes the safety and soundness of the commercial banking system; and the provision of some genuine reduction in the debt servicing burden now stifling growth in the developing world.

The urgency behind the Committee's call for the initiation of negotiations to create such an authority derives from the belief that current approaches to the debt situation have proven inadequate, that debtor nations today cannot sustain the debt burdens they now shoulder, and that the debt problem is a major component of the U.S. trade deficit.

Resolution of the debt problem in a manner that permits renewed and sustained growth in the Third World would make possible increased U.S. exports to these nations and would reduce the current pressure on those nations to maximize their entry into U.S. markets. Both effects would necessarily contribute to the reduction of the U.S. trade deficit, the ultimate goal of the omnibus trade bill.

The Banking Committee title provides flexibility for the Secretary of the Treasury to negotiate with our trading partners on the details of how such a debt authority would be structured and capitalized. The Committee does indicate its view of how such a facility would function.

First, the Authority would be empowered to acquire sovereign debt at a discount, which would be dictated by market forces. The banks would be required to accept the losses on these loans, but the Committee indicates in its regulatory study its willingness to contemplate appropriate regulatory relief, such as deferred loan loss recognition, in order to make any such losses sustainable without endangering investor confidence in depository institutions.

The Authority would then be able to work directly with the debtor country to restructure its debt portfolio such as a bankruptcy court might work with a troubled company. The aim should be to find creative new means of tapping the world financial market to provide these countries with the funds they need at a current price they can afford. At the same time, in conjunction with this assistance in debt restructuring, the facility would obtain commitments from debtor developing nations that economic actions will be implemented that will promote long-term sustainable growth. Such conditionality would enhance the marketability of

the restructured debt to new investors worldwide.

Among the creative new means of restructuring a debtor nation's debt obligations specifically cited by the Committee are debt/equity swaps, debt buybacks by the debtor at the discounted price paid by the authority, collateralization, and long-term securitization of the debt obligations.

With respect to capitalization of the Authority, the Committee expressed its sense that any capital required would be reduced by the nature of the Authority as a financial intermediary rather than a primary lender. That is, the Authority would function as a broker in moving short-term commercial bank debt into the secondary market in the form of new financial instruments. Such a conduit or pass-through function does not require the levels of capital necessary for a primary lender directly investing capital, in whatever form, into developing nations.

To advance the discussion of possible sources of the limited capital that will be required, the Committee authorizes studies of three possible sources: an insurance fund formed by transaction fees on the sales of these sovereign loans, the use of a small portion of IMF-held gold reserves as backing, and the similar use of limited amounts of uncommitted World Bank assets.

To insure progress in the conduct of these negotiations, the Committee title requires interim reporting by the Secretary to the Banking Committees of the House and Senate on a quarterly basis until the culmination of the negotiations. A final report would then be required with accompanying enabling legislation to provide for U.S. participation in this multilateral organization. U.S. participation and contribution to the Authority could occur only after Congressional passage of such enabling legislation.

agement effects, with environmental benefits attendant to both.

To the extent that recipients of Reclamation water continue to produce surplus crops the subsidized price of water will increase. This will encourage investment in water conservation, and free up new supplies of water for other uses or for maintaining or stream environmental values.

The application of this full cost pricing formula will reduce the political pressure for new Federal irrigation projects, avoiding the environmental damages that would result from the construction and operation of new irrigation works.

We welcome the introduction of the bill, and forwarded it to the early attention of the Congress and the Administration.

NATIONAL TAXPAYERS UNION SUPPORTS BILL TO REMOVE IRRIGATION SUBSIDIES
I am Jill Landwehr, Director of Congressional Affairs for the National Taxpayers Union. The National Taxpayers Union is a 180,000 member, non-partisan, non-profit public interest organization that fights to reduce the enormous Federal deficit, while reducing government spending and the two trillion dollar national debt.

I am here this morning to give our wholehearted support to the Irrigation Subsidy Reform Act of 1987 introduced by Representative Christopher, Sharp and Kildee today. We believe that it is imperative to stop subsidies to farmers for irrigation water irrigation projects. These projects are wasteful because they bring marginal land into production, which is already in surplus, the very crop that the government is simultaneously paying not to be grown.

Under current practice it is clear that the government's left hand does not know what the right hand is doing. Presently it asks the taxpayers to pay farmers NOT to plant certain crops that are in surplus. At the same time, taxpayers are asked to provide irrigation water to farmers at below market value to grow the very same excess crops. And, in many cases it is the same recipients who receive both subsidies. A situation that borders on the absurd.

The government's own statistics indicate that forty five percent of the lands irrigated with federally subsidized water are to be used to grow crops that the government is paying farmers not to grow. A reality that challenges common sense.

In fact, the current farm subsidy system hits the taxpayer not only with a double, but a triple whammy:

1. Tax dollars subsidize water to turn desert land into unneeded farm acreage used to grow unneeded crops;
2. Tax dollars pay farmers not to grow surpluses that are produced with subsidized water; and
3. Tax dollars help pay for storage costs when surplus crops are grown.

The American taxpayers can't help but be astounded, confounded and finally outraged about this nonsensical system of self-defeating subsidies. It is utterly inconceivable to ask taxpayers to pay for subsidy paid on subsidy on top of subsidy at a time when Congress is faced with short-falls in the \$180 billion range.

The legislation introduced today is a giant first step toward restoring a bit of sanity to the nation's runaway farm subsidy craze. This bill, by requiring farmers to pay full cost for irrigation water will help kill three birds with one stone. It will curtail the water subsidies, it will reduce payments for surplus crops and it will lower storage costs. The National Taxpayers Union joins with Representatives Christopher, Kildee and Sharp in urging the Congress to adopt this significant tax-saving legislation.

STATEMENT OF THE ENVIRONMENTAL POLICY INSTITUTE

Peter Carlson, Director of Water Resources for the Environmental Policy Institute in Washington, D.C., based public interest organization specializing in water policy and agricultural issues, issued today called upon the U.S. Congress to adopt reforms to end the contradictions between the Department of Interior Bureau of Reclamation and the Department of Agriculture practices with respect to surplus crops.

We are here today to endorse the legislation introduced by Rep. Christopher and co-sponsored by Reps. Kildee, Sharp and others to bring about an end to the absurd situation with respect to surplus crops and the Department of Interior Bureau of Reclamation. Carlson said.

In February of 1986, as a result of language inserted in Section 232 of the Reclamation Reform Act of 1982, the Department of Agriculture released a report, Production of Surplus Crops on Irrigated Land Owned by the U.S. Bureau of Reclamation, which once again brought the problem to the attention of Congress. There is an apparent inconsistency in some Federal programs restricting production and raising prices and farm income, while at the same time to increase the productive capacity of the agricultural resource base. Such inconsistency must put these two sectors at loggerheads, Carlson continued.

In the report, the Economic Research Service set forth full-cost pricing limits on use of water would be more effective than mandatory participation in marketing program inconsistencies.

We feel that Congress needs to bite the bullet on this issue with respect to the Reclamation program and take the first step to bringing an end to the problem," Carlson added.

In 1985, the Environmental Policy Institute published a report What Agricultural Subsidies?—A Survey of Business Leaders' Views on Land, Soil & Federal Farm Policy. The report was based on a questionnaire survey over the 1983-1984 period where the views of business officials from more than 250 corporations and agricultural trade or associations directly or indirectly involved in agriculture were solicited. One of the questions asked in the survey was, Should the federal government provide millions of dollars in subsidies for federal irrigation projects used to produce crops in some regions outside the Midwest which put farmers of these same crops in the Midwest at a competitive disadvantage?

Of those responding, 64.3 percent said no, 24.3 percent had no opinion and only 11.4 percent said yes.

We feel there is broad support for such action and we look forward to working with these Members of Congress and others in an effort to bring about a solution to this problem," Carlson concluded.

THIRD WORLD DEBT LEGISLATION

HON. BRUCE A. MORRISON

OF CONNECTICUT

IN THE HOUSE OF REPRESENTATIVES

Thursday, March 5, 1987

Mr. MORRISON of Connecticut. Mr. Speaker, I am today introducing legislation on one of the most important yet poorly understood issues we confront today: Third World debt and its impact on the United States.

The basic facts about Third World debt are widely known. First, the debt has become far more than they can now pay back. The total indebtedness of these nations can be calculated in various ways, but the best figures suggest that the debt now exceeds one trillion dollars. Even more startling, that debt has grown, not shrunk, since the onset of the chronic debt "crisis" that began in late 1981 and it has grown precipitously: from 1981 to the present, the debt has grown from some \$70 billion or over a trillion dollars—in a period when we were supposedly mulling of the crisis situation and taking various actions to deal with it.

Increasingly, our people are beginning to know and understand the tangible, down-home consequences of this seemingly remote problem. Stated simply, the debt problems of these countries have translated into the severe trade problems we face in virtually every locality in America.

Why? Because in trying to pay their debts to the commercial banks, including the major U.S. banks, these countries have pursued policies that have devastated American farms and factories. These nations are in an effort to be upstanding debt-paying members of the international financial community, have put their own people and their economies through the most severe and sustained buying less of the food and machinery we produce while selling us as much as they possibly can from their own farms and factories.

The stark result has been that the shift in the trade balance between the United States and the developing world has become a factor in our insupportably large trade deficit. Despite the general focus on our trade with Japan, the fact is that the debt-related shift in our trade with poor nations is a greater factor in our trade deficit problem than our trade with Japan.

For that reason, I am introducing this legislation today with the absolute determination to see that the problem of Third World debt is dealt with effectively and in a timely fashion, which Speaker Wright has earlier pledged to place on a fast track for passage this April, just 2 months from now.

Before discussing the details of my proposal, I want to say a special word of thanks to my colleague from Michigan, Representative Saxton. Saxton has been active on the Ways and Means Committee, but he also served on the Banking Committee in the last Congress and deserves special credit for the work he did last year in moving forward with a number of us on the Banking Committee to develop new and innovative approaches to this critical economic problem.

That collective effort has produced the legislation being introduced today, and our continued cooperative work will give us the promise of final legislation on debt that will be wise, fair, and effective.

Let me explain the gist of the bill that Representative Dixon, join me in introducing today.

The Debt Disincentive and Growth Promotion Act of 1987 has two key purposes. To reduce the dangerous level of exposure of U.S. banks to troubled foreign lending, and to assist with the economic growth and development in the poor nations of the world along with increased trade between the developing world and the United States.

March 5, 1987

To accomplish those objectives, the bill instructs the administration, specifically the Secretary of the Treasury, to immediately initiate negotiations with the industrialized nations—countries who have lent money to these countries and share these same problems—who also to create a new multinational entity to deal exclusively with this debt problem. The new entity would be a debt deconcentration facility.

The urgent need for a new institution to deal on a comprehensive basis with debt is very clear. Despite repeated assertions by private bankers and the Federal administration that the problem has been solved or that significant progress is being made on a middle-through, case-by-case basis, the facts belie this "whispering past the graveyard."

The facts remain that these countries are being strangled economically, our own trade picture is growing more bleak, and our banking system is more and more at risk. A new entity with full multilateral backing and a clear mandate would be able to provide the leadership on this issue, which we have not received from either the administration or the private banking sector to date.

The debt deconcentration facility we are proposing would be empowered to take the sovereign debt off the books of the commercial banks. The banks would be required to auction the losses on these loans to what would be dictated by the free market, that is, they would only receive for these losses what they are currently being booked by the banks. In order to make those losses manageable, however, the banks would be allowed to recognize these losses on a deferred basis, stretched over a period of years. That would mean that the banks accept a far loss on this lending, some of which was imprudent in the first place, but that any losses would not threaten the soundness of individual banks or the safety of our overall banking system.

Further, this facility would be empowered to deal directly with the debtor countries, much as the bankruptcy court might work with a troubled company, to restructure their debt. The aim should be to find creative new means of repaying the world financial markets to provide these countries with the funds they need at a current price they can afford. At the same time, in conjunction with this restructuring, the facility would obtain commitments from the debtor developing nations that economic reforms will be implemented that will promote sustainable economic growth and limit capital flight; such commitments will be a condition of the debt restructuring and reduction assistance offered by the debt deconcentration facility.

Here again, what is needed is leadership; there is no dearth of creative ideas about how this could be done.

For example, this morning's paper carries the news that Venezuela has just agreed to engage in some so-called debt-equity swaps to reduce its debt burden. This means permitting a creditor to exchange a loan asset for an equity holding in a company or of an asset such as oil reserves. Another, widely discussed idea that is beginning to be used involves changing this short-term, comparatively high-interest debt into other forms, such as securities, and moving them into the international capital markets. One of the reasons we are facing this problem is that the Third World countries have been excessively reliant on

commercial banks. Their debt is unnecessarily concentrated in the banks' hands, and they have not utilized the other capital sources that exist in the global financial markets.

The debt deconcentration facility would provide the expertise, the impetus, and the legal power to see that these creative new approaches to funding economic development and reducing the debt burdens of the Third World are effectively utilized.

The need for this new approach to Third World debt is urgent and urgent, and the Congress has an exceptional opportunity to act boldly now to face the debt problem. We can and I believe we will pass the legislation on debt as part of the omnibus trade bill that we intend to pass this spring, just a few short weeks from now. Already, the chairman of the International Development Institutions Subcommittee on which I sit, Representative WALTER FAUNTROY, has held hearings on the debt problem and has clearly stated his intention to mark up legislation on debt within the Banking Committee section of the trade bill. I welcome that commitment and I join with him and my other colleagues in our determination to act swiftly on this crucial problem.

Today's introduction of the Debt Deconcentration and Growth Promotion Act of 1987 is an important first step in providing an answer to this extremely serious economic challenge to the well-being of our farmers, our workers, our banks, and the thousands of people still struggling to achieve the prosperity in their nations that has blessed us here in the United States.

Following is a section by section summary of the Debt Deconcentration and Growth Promotion Act of 1987.

SUMMARY—THIRD WORLD DEBT BILL.
1. Title.—Debt Deconcentration and Growth Promotion Act of 1987.

2. Findings and Purpose.—Developing country debt now exceeds one trillion dollars, and developing nations are no longer able to sustain interest payments on that debt. Let alone repay the principal of those obligations. The debt crisis has three dangerous consequences.

Efforts to repay debt have crippled economic development in these nations. Their inability to repay their debt poses a serious threat to the safety and soundness of the U.S. commercial banking system, since major U.S. commercial banks are overexposed and could be bankrupted by widespread default or repudiation of this sovereign debt.

Their inability to repay their debt has seriously damaged the U.S. trade balance. Latin American efforts to limit imports from and expand exports to the U.S. have caused a greater negative shift in our balance of trade with those nations than we have experienced with Japan.

Therefore, the purpose of this bill is to promote growth in the developing world and expand trade between the United States and the developing world by restructuring and reducing Third World debt burdens; and

Protect the safety and soundness of the U.S. banking system by reducing commercial bank exposure and deconcentrating the holdings of developing nation debt by tapping the world capital markets through innovative financing techniques.

3. Debt Deconcentration Facility.—The Secretary of the Treasury is instructed to initiate negotiations with other industrialized nations to propose the establishment of a multinational financial institution which

would purchase sovereign debt from private creditors and enter into direct negotiations with debtor countries for the purpose of restructuring the debts to reduce these countries' current debt servicing burdens.

The facility to be an independent affiliate of the World Bank would not retain or hold the debt acquired from private creditors. It would operate as a financial intermediary or agent to restructure the debt portfolio of the debtor nation and to repackage and sell new debt instruments to new investors in the world capital markets. In so doing, it would be empowered to utilize such techniques as debt buybacks, debt-equity swaps, and securitization and collateralization of debt instruments of the debtor nation.

The facility would acquire the debt initially through buying obligations which would be backed by a contingent liability of the signatory nations, agreeing to creation of the facility, but those obligations would be covered by the funds acquired by the facility as it sold the restructured debt instruments to new investors. The intention of the bill is that the debt deconcentration facility should not involve the assumption of existing debt liability either by the World Bank, the new debt facility, or the signatory nations creating the facility.

4. Reporting Requirements.—The Secretary of the Treasury is instructed to report to the House and Senate Banking Committee within ninety days of enactment on the progress being made toward creation of the debt facility, and to report each ninety days thereafter until he presents the Congress with enabling legislation to create such a facility.

In addition, the Secretary of the Treasury, the Federal Reserve Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation shall conduct a joint study on the past profitability of commercial banks lending to the nine major money center banks over the past ten years, and shall submit such report to the Banking Committee ninety days after enactment.

5. Regulatory Reform.—In conjunction with the multinational negotiations mandated in Section 3, the Secretary of the Treasury shall propose that the signatory nations create the debt facility, that the necessary regulatory changes within their own regulation of commercial banks to facilitate the work of the facility. The Secretary shall specifically pledge that upon U.S. acceptance of membership in such a debt facility, deferred loan loss recognition would be permitted for losses incurred by commercial banks in transactions with that facility.

After the United States accepts membership in such a debt facility, any restructured agreements between commercial banks and developing nations shall be subject to certain limitations, including a limit on interest charged to the actual cost of funds as measured by the London Interbank Offered Rate (LIBOR), and a limit on restructing fees and associated charge to actual costs incurred in the restructing transaction.

For a period of five years after the regulatory changes take effect, transactions with the debt deconcentration facility may not be taken into account by bank regulatory authorities in appraising the value of, classifying, or imposing reserve requirements will respect to other sovereign debt still held by commercial banks.

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Written Statement of Congressman Charles E. Schumer
Before the subcommittee on International Finance and
Monetary Policy of the Senate Banking Committee

April 3, 1987

Mr. Chairman, members of the subcommittee, I thank you for the opportunity to report to you on action taken in the House Banking Committee with respect to the problem of the debt burden of Less Developed Countries (LDC's).

The problem of third world debt has concerned me for over four years. As we all know, the 1982 debt crisis was sparked by the inability of Latin American countries to service their commercial debt (which had accumulated in the 1970s). At first, this crisis was perceived as a short-term liquidity crisis, that could be resolved with stop-gap new loans. As a result of this perception, a situation developed which elsewhere I have called "faustian finance." Both debtor nations and creditors made faustian bargains whereby new loans would be advanced to allow countries to meet payments on the old loans. The countries were able to meet scheduled payments but piled debt on debt. The banks were able to record quarterly profits, but with increased exposure and increased vulnerability to loss due to default.

Since 1982, this cycle of lending new money to cover old interest payments has continued. Successively, countries have run into trouble, been offered rescue packages, staved off default for a year or two, and then repeated the cycle. Simultaneously, as Senator Bradley has so eloquently pointed out, the debt crisis has had an adverse impact on our trade balance and on our employment situation.

For these reasons, Congress has taken a growing interest in this issue, and for the first time, concrete legislation has been proposed as part of H.R. 3, the omnibus trade bill, in the House of Representatives. My colleagues, Mr. LaFalce and Mr. Morrisson, have presented testimony on the portion of the bill that concerns the creation of a facility to purchase the LDC debt at a discount and subsequently pass that discount along to the debtor nations. I will limit my testimony to a description of my portion of the bill, included in Subtitle B, chapter 3, which I call the options plan for third world debt relief.

The options plan offers banks a non-mandatory way to provide debt relief to Less Developed Countries. It can take effect immediately, unlike other proposals which depend on the Treasury Department to initiate multilateral negotiations. It comes from the realization that a "forced solution" to debt relief will not work. No one, least of all the United States Congress, can mandate a solution without the agreement of all the concerned parties. The options plan seeks to capitalize on the

fact that some banks and many debtor countries wish to choose other methods to meet debt payments than lending new money. Particularly small and mid-size regional banks and some foreign banks have privately, and increasingly in public, expressed a desire to reduce their current exposure.

Under the options plan, each bank could still choose to lend new money (as is current practice) but it could also choose to:

- forgive a portion of the debt
- forego or reduce interest payments
- engage in a debt-equity swap
- combine any of these options

If the options plan is implemented, negotiations to reschedule the debt would occur just as they do now. The debtor nation in simultaneous negotiations with the International Monetary Fund (IMF) and the lead bank (representing the committee of banks that hold loans) would put together a package which would include economic reforms in return for favorable terms for repayment of its existing debt. Traditionally, the lead bank (a money-center bank) has found it profitable to continue the cycle of lending new money to allow the country to meet its debt service obligation. All other banks are pressured to follow the lead of the big money-center banks. The options plan gives these banks the opportunity to break the cycle of lending new money to pay back old loans.

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After the negotiations, the federal regulatory agencies and the Treasury Department would be required to publish a table of mathematical equivalences stating the amount of interest reduction or debt forgiveness or debt-equity swap which is equal to lending new money.

For example, if it is established that a given bank's negotiated share is \$1 million, it could choose to lend this amount in new money, OR, it could choose to:

- forgive a percentage of its existing debt equal to \$1 million,
- reduce interest payments by a percent equal to \$1 million,
- commit to a debt-equity swap equal to \$1 million in new money,
- or combine these options (lend \$500,000, and reduce interest payment).

We believe that many of the small and mid-size regional banks and some of the foreign banks will choose these options rather than lend new money.

No bank is required to choose any one option over the other. The plan applies only to future debt reschedulings; it does not affect past reschedulings.

The options plan has a number of advantages. Among these are:

1. It is a true case by case approach that allows banks maximum flexibility in managing these loans. A bank could choose one option in one rescheduling and another option at another rescheduling.
2. It overcomes the primary obstacle to legislation on this issue because it doesn't impose action on the U.S. banks that places them at a disadvantage with respect to European and Asian banks, who hold more than half the commercial debt.
3. It will strengthen the secondary market, which is also the goal of the multilateral facility. As banks begin to choose other options than lending new money, they will look for a way to dispose of their loans, increasing the need for a coordinating facility to manage the growing secondary market.
4. It acts upon the statements from the Treasury Department and some bankers advocating more flexibility and creativity in responding to this situation. I believe, yesterday, in testimony before this subcommittee, Mr. Colman, Vice President of Philadelphia National Bank, urged that banks be allowed to choose alternatives to lending new money in future reschedulings.

The options plan is a first step towards sound management of the debt crisis. We do not anticipate that a large number of banks will immediately take advantage of options other than new loans, but our perception is that as much as 10-20 percent of the debt would be treated in a different way. If this is the case, then we should see the beginnings of real relief flowing to debtor nations, while at the same time preserving the freedom of choice of the banks. It would also demonstrate to the money-center banks, to the Treasury Department, and the IMF, and other parties involved that these other methods of relief can work, and without disastrous consequences for the banks.

THE SCHUMER OPTIONS PLAN

I. SUMMARY

1. The Schumer options plan is the first piece of legislation that offers banks a non-mandatory way to provide debt relief to Less Developed Countries. It can take effect immediately, unlike other proposals which depend on the Treasury Department to initiate multilateral negotiations. It comes from the realization that a "forced solution" to debt relief will not work. No one, least of all the United States Congress, can mandate a solution without the agreement of all the concerned parties. The options plan seeks to capitalize on the fact that some banks and many debtor countries wish to choose other methods to meet debt payments than lending new money. Under the options plan, each bank could still choose to lend new money (as is current practice) but it could also choose to:

- forgive a portion of the debt
- forego or reduce interest payments
- engage in a debt-equity swap
- combine any of these options

II. HOW IT WORKS

1. Currently, the debtor country negotiates to reschedule its debt with a lead bank (representing the committee of banks who hold loans). Simultaneously, the International Monetary Fund extract concessions on economic reform from the debtor nation, and in turn, the bank agrees to lend new money allowing the country to pay interest on its previous loans. Under the Schumer

options plan, these negotiations would occur just as they do now.

Traditionally, the lead bank (a money-center bank) has found it profitable to continue the cycle of lending new money to allow the country to meet its debt service obligation. All other banks, are pressured to follow the lead of the big money-center banks. The options plan gives these banks the opportunity to break the cycle of lending new money to pay back old loans. 2. After the negotiations, the bank regulatory agencies and the Treasury Department shall publish a table of mathematical equivalences stating the amount of interest reduction or debt forgiveness or debt-equity swap which is equal to lending new money. Each bank will then choose the option that best suits its needs. For example, if a bank's negotiated share is \$1 million, it could choose to lend this amount in new money, OR, it could choose to :

- forgive a percentage of its existing debt equal to \$1 million,
- reduce interest payments by a percent equal to \$1 million,
- commit to a debt-equity swap equal to \$1 million in new money,
- or combine these options (lend \$500,000, and reduce interest by the appropriate percent).

3. The banks are not required to choose any of the options, nor are they forced to participate in the rescheduling. The plan applies only to future debt reschedulings; it does not affect past reschedulings.

III. OPTIONS PLAN ADVANTAGES

1. It can become effective immediately. No long-term negotiations are necessary.

2. It overcomes the primary obstacle to legislation on the debt relief issue because it doesn't impose action on the U.S. banks that places them at a disadvantage with respect to European and Asian banks, who hold more than half of the commercial debt.

3. It is a true case by case approach because it allows debtor nations and creditors to choose different options at each rescheduling, rather than requiring them to stick to one course of action (i.e. lending new money) at all reschedulings.

4. It will increase the size of the secondary market for LDC debt, something which all experts agree would be a positive step.

5. It complements and acts upon the positive statements made by representatives of the Treasury Department and the banks that there is a need to move towards flexibility and a wider range of choices for banks.

Senator SARBANES. Well, gentlemen, thank you very much, not only for your testimony, but for the very effective and constructive work you've done in the House in the course of the markup of the legislation that is before you, and of course, we have been following your efforts very closely and continue to do so and also to take a very careful look at what you've done. I think you've really done some pathbreaking work in the course of your markup, and we appreciate that very much. Senator Gramm?

Senator GRAMM. Well, thank you, Mr. Chairman. I got my note I ran out of time just as there was one point I wanted to make in response to Senator Bradley.

It is true that the equity markets in the Third World are very small, and that is part of the problem. That doesn't mean there's not a lot of equity in the Third World. PEMEX is a parastatal. That doesn't mean that it doesn't have value, that the oil reserves it holds don't have market value, and I am sure that there are a lot of banks in New York and maybe some in Dallas and Houston—I hope not too many.

Mr. SCHUMER. Do you have any banks left in Dallas or Houston?

Senator GRAMM. A few. [Laughter.]

Not as many as we would like.

That there are a lot of institutions that would love to trade some debt for some of those oil reserves, even though they are not reflected on the equity market.

OPPOSITION TO BAKER PLAN

Let me first say that I am in total agreement with you concerning the problem. While I am a great admirer of our Secretary of the Treasury, I don't think his plan is a very effective way to deal with the problem. And No. 2, I think that this treadmill we are on, where the problem gets worse, you lend more money to pay interest is clearly not going to work. Now we made progress since 1982 in strengthening bank reserves, and I am grateful for that, and maybe if you look at that as an achievement of the Treasury, that that is no throw away achievement. But in terms of getting where we want to be, obviously, what we are doing, in my opinion, is not going to get us there.

I would like to ask you a couple of question, more to get your thinking than in any way to try to be critical.

First of all, in terms of a secondary market for Third World debt, there is a secondary market out there. It is pretty small. My guess is, it is small for a couple of reasons: No. 1, that these financial institutions that hold Third World debt or having it valued by regulators as if it were IBM stock or bonds, and so they are taking a big hit when they try to sell it, but on the other hand, it's not being reflected on their balance sheets. And so taking the hit officially by selling it on a secondary mortgage is not terribly appealing.

I guess I wondered, and I would like to get your reaction, we are living—and obviously, your program would be working—in the world's greatest market system. If we had some effective, either general or specific reserving against this debt required—you know, I don't know how our chairman feels, but every regulator that

comes in here says we need to do more, and then when you ask them why they don't do more, they don't do more, because they are not ready to do more. [Laughter.]

I just wonder if we begin to raise the cost of holding this debt by making the audits of our regulatory agencies more nearly reflect value, if we wouldn't create this secondary market without having to go out and create an agency to create it.

SECONDARY MARKET

Mr. LAFALCE. Well, let me just try to make an initial stab, and then I will defer to my colleagues on that.

First, with respect to one of the points you made, you said that the Baker plan has permitted the bank to build up reserves, and that some good has come of it. That is very true. Also, they have been able to use this time to increase their capitalization, and that is very good. So they are in a much better situation to deal with the problem now than they were before.

On the other hand, from 1982 to the present, no plan, no course of action has done anything to help the plight of the sovereign powers. As a matter of fact, their situation has become, in some instances, considerably worse. Generally speaking, the standard of living of most of these countries has declined by perhaps 10 to 15 percent or so, and as they built up more debt. The situation is getting worse for them. Finding the way out is worse. So we have got to factor that in.

Second, there is absolutely no dichotomy between what you are suggesting and what we are suggesting. As a matter of fact, I see them as highly complementary and in some way encouraging, if we may use the word "encourage," the banks to increase their reserves even more, I think could be very, very helpful.

Generally, the foreign banks have reserved more than our domestic banks. Generally speaking, our banks have reserved more in the past 1 or 2 years than they did beforehand, but I think more of that is certainly called for. And it would be an incentive, it seems to me to utilize the secondary market more; however, I think the secondary market is so thin that we need a third party player involved in it to help facilitate that market.

THIRD PARTY DEBT MANAGER

Also, above and beyond the facilitation of a secondary market, it seems to me we need a third party debt manager, in order to bring all these parties together. Otherwise, you know what we are going to wind up with. We are going to wind up with the foreign policy of the United States being dictated, in large part, by the bank that happens to be chairman of the bank committee for a particular country. I mean, with one country, it could be B or A, with another country, it could be Citicorp.

These sovereign borrowers don't really have a forum where they can sit down with anybody other than the bankers. Right now, Brazil, for example. I was talking with the president of the Central Bank of Brazil and Mexico.

You know who he's negotiating the future of Brazil with?

It is really not Baker or Volcker or President Reagan. He is negotiating with Bill Rhodes of Citicorp.

Senator GRAMM. Well, now I'm not ready to conclude right out of the chute that obviously that's bad.

Mr. LaFALCE. Well—[Laughter.]

Mr. MORRISON. Senator, if I could just add something and answer your question. First of all, I—

Senator GRAMM. At least we know Citicorp's got more at stake. [Laughter.]

Mr. MORRISON. Senator, if I could just—first of all, I think it is an excellent question, and I think it gets at an important point. I think reserving very well can be a part of the solution, but the secondary market that currently exists, as was explained earlier, doesn't help the debtor nation, because it is really a market for speculators. It is people who buy devalued securities in the hope that they can realize more than their discounted price. What the facility aims to do is to pass through the benefit of the discount to the developing country and give them a better opportunity to become truly creditworthy down the road and without the facility, I don't think you can do that, and in conjunction with the facility, you can make the changes both within the country and in the nature of the backing of the debt instruments that make them pay 100 cents on the dollar instead of the 65 or 70 cents that they would pay now.

Senator GRAMM. Well, I see my red light's come on, but let me make this point, that I don't write off the ability of markets to work in the following manner, that when a secondary market is created, and we know that our society is better at creating markets than any other, that when that market is created, the people who are going to buy this debt are going to be people who primarily are going to try to specialize in use and collection, and their ability to work out systems within an overall market, I think, is something that we ought not to discount.

Now obviously, if we can set up the structure of our relationship with the Third World debtors in such a way as to facilitate that, I think that is good, but I am familiar with a lot of cities in my old congressional district that went through an oil boom in the 1920's, and they went out and borrowed a lot of money, and then they couldn't pay it back, and they defaulted. And what happened is, the holders of that debt ended up selling it in a secondary market. Over the years, it went through the whole financial system, as people wrote down their losses. It ended up in the hands of people who specialized in collections, and these cities started to recover, they ended up negotiating out agreements to pay this debt off, sometimes at 10 cents on the dollar, sometimes at 50 cents on the dollar. And all that was done by market forces.

So I am not saying there aren't things that we ought to do. I am certainly willing to look at what you propose, because you put a lot of thought in it.

Mr. SCHUMER. Senator, just one other point—

Senator GRAMM. The point I want to make is that if we have something that works with market forces, it is going to work a lot better than if we have something that works against them.

DEBT RESCHEDULING

Mr. SCHUMER. Senator, the only point I would make is—this is not in reference to the facility, but what the options plan seeks to do is do just what you said. Right now, is, you know, there is sort of a cartel, both a practical and a theoretical cartel. If a bank in Waco, TX, only has \$2 million of lending, and they want to pursue another method of debt relief, they can't do it. They are locked into lending more money. And what the options plan would do—the part of the House proposal that is the options plan, it says, you go pursue another method of debt relief in the secondary market, or whatever, on your own. And it only deals with—and I appreciate my colleague reminding me is—is new rescheduling. So I would urge you to take a look at it—

Senator GRAMM. I will.

Mr. SCHUMER [continuing]. Because it is in line with what you are talking about.

Senator SARBANES. Well, gentlemen, we have a vote on. That is the second call of the bell. So we are going to have to adjourn the hearing.

This has been a very—

Mr. LAFALCE. Is it the highway vote?

Senator SARBANES. Well, actually, it is a call of the Sergeant at Arms, but it will relate eventually to the highway bill.

But again, we very much appreciate your testimony.

Let me say just one word about Secretary Baker, because I do think he's taken some initiatives—I just want to put this on the record—that have been very helpful, when he got over to the Treasury.

First of all, he addressed the overvaluation of the dollar problem, which I think had a significant impact on the trade question, and second, I think that he's—I mean, I am not sure I agree with what he is doing right now. That is arguable. But I think over time since he's been there, he's focused on that question. I think right now he's kind of got himself caught in these understandings.

And the other thing is, I think his proposal on the Third World debt, while it does not go far enough, at least was a turnaround from imposing this incredible austerity program on the debtor countries, with all of the impact that that had, internally, in the debtor countries, on our producers, and so forth.

Now I think we are trying to push him to go further, and I think that is one of the things we are trying to do in this legislation, obviously. Yes?

Mr. LAFALCE. Mr. Chairman, some people have characterized the Baker plan as a bold initiative and others have characterized it as a wet noodle. A good many have concluded that perhaps it is called a bold noodle. [Laughter.]

Senator SARBANES. We thank you very much.

The committee will stand in recess, and we will resume with the next panel in about 10 minutes.

[Recess.]

Senator SARBANES. We are prepared to resume. Let me simply explain to our witnesses—and it's not a matter over which I have any control—there have been two votes in succession and there

may be more and we'll just have to move along as best we can. I think as most of you know, the question of the override of the President's veto of the highway bill is the matter now before the Senate. In fact, the President is now on the Hill speaking to the Republican Senators and I just don't know when we'll have more votes, but we will try to move as expeditiously as we can.

We are very pleased to have this panel and, Mr. Dornbusch, why don't we start with you and then we'll move straight across to Karin Lissakers and then over to Andrew Quale. Why don't you begin?

STATEMENT OF RUDIGER DORNBUSCH, MIT

Mr. DORNBUSCH. Thank you, Mr. Chairman.

Senator SARBANES. Your full statements will be included in the record as submitted and if you could hit the high spots we would appreciate that.

Mr. DORNBUSCH. I welcome the opportunity to present to this committee my views on debt problems and on reasonable solutions. I would like to note first that there has been no progress on the debt problem, contrary to the official propaganda, and that is apparent in four ways.

NO PROGRESS ON DEBT PROBLEM

The first is that creditworthiness of major debtors has in fact not improved. Today the ratios of debt to GNP and debt to exports are higher than they were in 1982. Their debts trade at discounts of an average of 40 percent in the secondary market.

Second, investment in Latin America has fallen by 5 percent of GNP, exactly the improvement in trade balances necessary to pay interest. Latin America therefore is paying interest by not investing. That is not sustainable and indeed builds up bottlenecks to any likelihood of sustained growth.

Third, the idea that voluntary lending should resume is becoming increasingly unlikely. The case of Colombia is striking. The country so far has not had any reschedulings. When coffee prices fell and the country tried to borrow, it found out that simply being located in Latin America was enough to preclude lending from banks.

Finally, there is the U.S. trade problem associated with debt collection. Latin America's manufacturing balance with us has swung by \$15 billion. The entire LDC balance, by nearly \$50 billion. That shows that debt interest is being paid to a significant extent at the expense of U.S. manufacturing.

For countries that have been successful in developing their exports, the case of Korea is the most striking. The country today insists on running a current account balance in order to pay off debt because the debt process is so frightening.

RESTORE RESOURCE FLOW TO DEBTOR COUNTRIES

The basic problem that needs to be resolved is how to restore resource flow to debtor countries. Today resources are moving away from them as interest is being paid. They run trade surpluses. Developing countries should be running trade deficits supplementing

domestic saving with external saving to achieve high investment. There is no prospect of that and any solution to the debt problem must attack this basic issue.

Most solutions discussed—and particularly the Baker plan—do not look at that problem. They are concerned with managing short-term crisis, not at reversing the resource flow.

I'm particularly skeptical of the Baker plan with its equity fetish and free market fetish because it places in entirely wrong perspective what reasonable market forces can do to a debt overhang.

Of course, debt-equity swaps are a good idea. Direct foreign investment is important, should have been larger. Privatization of PEMEX is a wonderful thing, but all of that has really nothing to do with finding \$30 billion a year to pay interest. It's entirely out of proportion. It's a long-term issue—free market, economics, foreign investment. The emerging issue that needs immediate attention is how to reverse the resource flow.

Among the solutions that stand out—and I recognize that there's a broad range of solutions that need attention—of course, the Bradley plan was the first to draw attention to the need to reduce debt burdens rather than pile debts one on top of the other, and to do so in a way that limited targeted selective conditions links it to our trade interests.

I believe that the initiative that you are proposing, Mr. Chairman, is exactly in that direction, to use the existing secondary market as an institutional vehicle to pass on discounts on debts in the secondary market as debt relief to developing countries, to debtor countries, and to do that in a way that assures that in those countries growth prospects, stabilization programs, trade policies, are better.

I believe that a fund like this, well-structured, run by the United States alone rather than internationally targeted to other than the four large debtors and using as taxpayer support only guarantees can in fact be important. It can achieve a reduction in interest payments owed by developing countries of 20 percent. That would be the extent that can be achieved.

The large debtor countries—Brazil in particular—I believe have to do unilateral action announcing their own capitalization schemes to cut the knot where now neither regulators nor governments nor banks have the initiative to move because everybody hopes that something will change or someone else will move.

Thank you very much.

[The complete statement of Rudiger Dornbusch follows:]

THE WORLD DEBT PROBLEM: ANATOMY AND SOLUTIONS1

Rudiger Dornbusch
Massachusetts Institute of Technology

The adjustment process to the debt crisis is no longer credible. Favorable conditions in the world economy and the beneficial effects of adjustment programs on the part of debtors were expected to show in time an improvement in credit worthiness sufficient to warrant a return to voluntary lending. That remains the expectation, but the process is not on schedule. A return to voluntary lending is very remote if one judges by the large discounts in the secondhand market for LDC debts.

While there is always a story of improvement, the picture remains in fact unchanged: there is a debt crisis. Moreover, there is concern that conditions may deteriorate: Over the past four years the non-interest current account of Latin debtors turned toward a large surplus as Latin America managed to pay a significant share of the interest liabilities. But at the same time their investment declined sharply. For a brief period a cut in investment may be a reasonable response to the crisis, but when it lasts it cannot but lead to severe trouble.

Policy makers in debtor countries are concerned that ultimately they will bear the costs for prolonging what they consider a totally unreasonable decapitalization of their economies. Surprisingly no populist government has come to power yet to dramatize this issue. But it is clear that in Brazil, Mexico and Argentina the issue is buried only a foot deep.

On the side of creditors there is also a deterioration underway. Large banks who are organizing the lending cartel are increasingly disenchanted with Federal Reserve pressure to keep up lending. They would have liked to see a more substantial takeover of the tax payer, overtly or under the cover of expanded loans and guarantees from international agencies. The problem is aggravated by the increasing unwillingness of small banks to participate in new rounds of lending. Their withdrawal puts pressure on loan discounts and thus highlights that loans are traded significantly below par.

A final dimension of the crisis is the trade issue. This aspect has been emphasized by senator Bradley in his proposal for limited, selective and targeted negotiation of debt relief in exchange for conditioned adjustment programs and trade concessions in the debtor countries. Debtor countries today run trade surpluses to earn dollars for debt service. They have achieved these surpluses by large depreciation of their currencies to gain competitiveness, by restrictions on imports and by an expansion in exports. But this large swing in their trade is perceived as a threat to a liberal world trade regime.

Three facts summarize the lack of success of the adjustment efforts so far:

• Creditworthiness has been deteriorating. The ratio of debt to exports for problem debtors has risen since 1982 from 254 % to 282% and the

1Statement before the Subcommittee on International Finance and Monetary Policy of the Senate Banking Committee, April 2, 1987.

ratio of debt to GDP increased from 43% to 49%. Five years of adjustment thus have made debtor countries look worse rather than better, at least in what concerns their debt burdens.

The large swing in trade surpluses which finances today much of the interest payments has a counterpart a decline in investment. Comparing the period 1982-86 with the preceding five years average there is a 5% of GDP increase in Latin America's noninterest surplus and exactly equal decline in investment. When interest is paid by not investing a serious imbalance is building up.

There is no indication of a return to voluntary lending. Loan discounts are very deep for most debtors and the case of Colombia shows that even clean debtors cannot gain access when they do face a shortage of foreign exchange.

FOUR PROBLEMS

The basic problems to be solved are four. One is how to reverse real resource transfer and restore the flow of development capital to the debtor countries. Their noninterest surpluses which today service debt need to be turned into deficits again to provide a net resource import to supplement domestic saving in financing growth.

As long as existing debts are judged to be poor, commercial banks will be reluctant to put up new money to finance at least the interest bill. And they will most definitely not lend over and above the interest bill to finance a net resource transfer. The problem goes further because the existing debt has a prior claim on the debtor countries' resources. It therefore stands in the way of new resources from potential lenders or investors who have so far not been involved, say insurance companies. The existing debt also places a burden on debtor countries' policies and thus deteriorates the profitability of direct investment in these depressed or slow-growth economies. Finally, the political backlash in response to the debt collection process may well come one day and, at that point, there is no assurance of a fine distinction between uncooperative banks keeping alive long-dead debts and new investors. In summary, until the problem of old debts is resolved, one way or another, fresh capital resources will be very timid.

The second problem is that even though the market judges that the debt's of problem debtors are only worth 61 cents on average (thus clearly indicating the possibility that some of these debts in the end will not be paid) debtor countries receive no benefit from these implicit write-offs. When a small bank takes a loss, selling off a claim on say Bolivia, at 9 cents on the dollar the buyer acquires a claim with uncertain payoff that he will seek to enforce to the full value. The debtor country still owes a dollar and thus bears the full burden of trying to service that debt. The burden, even if nothing is paid in fact, takes the form of uncertainty which has an adverse effect on the macroeconomic environment. Thus not only are there no net resource transfers, even countries who are not paying still suffer from the lack of resolution about their ultimate debt service liability. This uncertainty in itself may be costly for both creditors and debtors, raising the possibility of write-offs that help all parties.

The third set of problems involves the commercial banks, their ability to take accounting losses involved in any debt consolidation and the ease or difficulty posed by the regulatory environment. The issues that arise here stem from the divergent interests of large and small banks, and the differences between U.S. banks and those abroad. It also involves the fact that the U.S. regulatory environment remains consciously ambiguous on the consequences of consolidation. There is little doubt that ex post the costs to banks will be minimized. But ex ante consolidation is discouraged by regulatory difficulties that make it very expensive for banks. This may represent a strategy of the regulatory authorities to discourage any excessive eagerness on the part of creditors to give in to consolidation. Of course, it thereby also stands in the way of reasonable settlements for some claims which, as a result, may deteriorate.

The fourth problem concerns the difficulty in creditor countries to reconcile the conflicting interests of commercial banks, foreign policy and manufacturing. The concern to maintain the stability and profitability of the banking system is rightly singled out as an important national objective. But it may compete with other objectives: our interest in stable democratic governments on our borders is one, and our interest in the health of our own manufacturing sector which pays some of the costs of debtor country adjustment is another.

In fall 1985 Secretary Baker proposed a broad-ranging, ambitious plan to cope with the debt crisis. At the center of the plan was the recognition that the debt problem will not go away rapidly and that debts should be serviced and ultimately paid. The strategy to assure that this would in fact happen involves five elements:

- . Continued involvement by commercial banks who are to contribute "new money" as required in the rescheduling of debt.
- . Sharply increased participation and lending by multilateral institutions, specifically the World Bank.
- . Focus on debtor country adjustment; not only by belt-trimming of the 1982-84 variety, but also a positive focus on free enterprise and supply side economics.
- . A world macroeconomic environment that supplements adjustment of debtors by sustained growth.
- . A world trade environment of continued and enlarged market access for everyone.

Other than in the form of increased lending by multilateral agencies the Baker plan had few concrete implications. It represented primarily an approach to the debt problem and philosophy. At that general level there is, of course, little disagreement. But without any specificity, there was also very little that could be endorsed. The expectation that the private market could solve the debt problems by a return of capital flight, debt-equity

swaps and foreign direct investment exaggerated the likelihood and magnitude of these flows. The expectation that privatization and increased efficiency in government can make a significant contribution in the short run to a debt overhang problem is bound to be disappointed. Accordingly there is a need for a change in strategy. Henry Kaufman has emphasized that this is not merely in the interest of debtors, but in fact is of global importance.

"The rapid buildup in bank lending to developing countries in the 1970s gave world economic activity a temporary boost. However, the current adherence to the creditor/debtor commercial arrangements is a powerful limiting force to world economic expansion. The restrictiveness of this debt cannot be denied. If the debt blockage is not eased, economic growth globally will continue at only a slow pace, risking a major worldwide business setback."

SOLUTIONS TO THE DEBT PROBLEM

Solutions to the debt problem must address two questions: The first is who pays for the debt relief --the debtor, the bank stock holder, Japan or the tax payer? The second question is who takes the initiative-- creditor governments, debtors and creditors jointly, or debtors unilaterally?

There are basically three directions worth exploring: a change in regulatory environment which now raises the costs to banks of limited, selective write-offs or concessions, the plan of an international facility which buys up and/or guarantees LDC debts and as part of the arrangement secures limited debt relief, and third unilateral action by debtors.

Regulatory Problems

The willingness of banks to enter discussions on debt relief is limited by two factors. The first is a very unfavorable or at least ambiguous regulatory environment. At present the granting of debt relief on part of the loans to a particular country would impair the entire principal and require reserve provision and accounting losses. This reflects the absurdity of a situation where making loans better (in the sense of reducing the probability of repudiation) forces a write-down while hardline collection does not, even if it reduces the secondary market valuation.

These regulatory provisions may reflect a strategy of raising to banks the costs of concessions. But they also they invite games of playing chicken which may ultimately be much more expensive than a more open system where banks and debtor countries can negotiate write-offs and corresponding performance conditionality.

The same regulatory issue arises in respect to sales of claims at less than face value. If a bank should sell off in the secondary market part of its claims on a particular country the regulatory authorities now require that the remaining part be written-down by the discount at which the debt was sold. That in turn increases the reluctance to sell and limits the growth of the secondary market. It implies that LDC debt remains trapped in the wrong places which in turn makes the rescheduling process much more tedious..

There is also ambiguity about the role the tax payers will play. The possibility that the tax payer could enter, directly or via a sharply increased funding of the World Bank or a new institution, means that it would be outright premature to talk of concessions. Countries should borrow rather than adjust and banks should lend at as high interest rates as possible. It is difficult to see how to establish a precommitment that defines the limits on the role of the tax payer and thus helps get on with voluntary deals between banks and debtors. But along with more clarity on the regulatory treatment there is a need to define more clearly what the tax payer is willing to do.

Interest Capitalization

With these obstacles out of the way it is worth considering the proposal advanced by Swiss bankers. They recommend the automatic capitalization of interest payments substantially at the discretion of the debtor.² The system is designed to minimize the possibility of confrontation in the context of a liquidity crisis and thus eliminate any plausible excuse for default. The system runs directly counter to the concerns of U.S. banks who insist on the full current payment of interest and reject capitalization.

In the Swiss proposal automatic capitalization has as a counterpart objective indicators that trigger enhanced debt service. These would involve, for example, for an oil exporter the price of oil. If oil prices come to exceed a particular level increased revenues would be used to bring debt service up to the full level and perhaps for amortization of principal.

The attraction of the plan for European banks is that they have set aside reserve provision amounting to a large part of their claims. Hence any receipts are good news. The U.S. banks, by contrast are excessively concerned with quarterly receipts and thus severely aggravate the debt problem by forcing debtor countries into much more dramatic adjustments. The attraction of the plan is that it improves debts by relaxing the timing of interest rate receipts. In doing so it removes the risk that a debtor, strained by excessive insistence on current service, might default. But at the same time the scheme also means that creditors forego some of the control that they are now organizing by requiring programs as part of rescheduling. There might be a middle ground between the quarterly routine that is practiced today and the infinite horizon of a Swiss banker.

The Swiss proposal is very different from a scheme where there is an automatic cap on interest payments, say at 6 percent, with the excess automatically forgiven. The Swiss scheme implies that the portion that is capitalized retains an option value, should matters improve. The alternative scheme makes an automatic and unconditional gift to debtors, even if their conditions should subsequently improve. Needless to say the Swiss proposal is more attractive since it affords banks with an opportunity to make larger

²Such a proposal was presented by Franz Luthof, the president of a major Swiss bank, at the December 1986 Congressional Summit on Trade and Debt in New York and in the *Neue Zürcher Zeitung*.

concessions today because they have as a counterpart the potential of a pay back down the road.

It might be argued that the present rescheduling practice is not very different from the Swiss proposal. After all, when countries cannot pay creditor banks grant loans as "new money" to pay the interest they owe. The difference is that the Swiss proposal goes much further. It not only removes the difficulty and confrontation of rescheduling and the problem in organizing the cartel. It locks all creditors into the refinancing in a way that is now impossible. And, most importantly, it gives macroeconomic planning a much longer horizon because it removes the threat that a country cannot come up with a rescheduling agreement and is forced to chose between a dramatic depression or an equally dramatic default. The resulting uncertainty is, of course, a major mortgage on investment and growth. The Swiss proposal is a front end commitment that says if things are bad the debt is forgiven and if they turn out well it is payable in full.

The Facility

The stock of old, bad debt stands in the way of a resumption of lending. Since Kenen first advanced the proposal there has been an interest in the idea that there is a need for moving debt, which is now trapped in the hands of banks out into some facility, achieving in the process both an improvement in bank balance sheets and a reduction in debt burdens for the debtors. The idea receives reinforcement from the highly visible discounts in the secondary market which suggest that a facility could buy up debt and pass on partial relief to debtors if only the right institutional vehicle could be created. The resolution may be a "facility" which takes over debts from banks and renegotiates them with debtor countries. If the facility enjoys a government guarantee significant debt relief becomes in fact a possibility.

Table 1 Some Problem Debts
(Billion \$. Percent of capital and cents per dollar)

Country	Total Debt (\$bill)	Debt to US Banks				Prices (Cents/\$)
		All Banks \$bill	%	9 Banks \$bill	%	
Argentina	50.8	8.4	7.6	6.0	13.6	65.0
Brazil	107.3	22.2	20.1	15.2	14.4	64.0
Chile	21.0	6.5	5.9	4.1	9.3	68.0
Colombia	11.3	2.2	2.0	1.6	3.6	86.5
Mexico	99.0	24.2	21.9	13.5	10.5	57.5
Nigeria	19.3	0.9	0.8	0.7	1.6	37.0
Peru	13.4	1.5	1.6	0.8	1.8	19.0
Philippines	24.8	5.1	4.6	3.7	8.4	70.0
Uruguay	3.6	0.9	0.8	0.7	1.6	72.0
Venezuela	11.6	9.7	8.8	6.9	15.6	75.0

average of bid and offer price in cents per dollar debt, March 9, 1967.
Source: Federal Reserve, World Bank and Dealer Information

The notion of a facility to absorb bad debt starts from the recognition that banks are overexposed to LDC debtors. The financial system suffers as a result of the fragility of banks and the debtors suffer because the debt service exceeds their ability to pay under conditions of growth and political stability. There is an obvious opening for the tax payer to step in. A public body would be created with the task of bringing about renewed resource flows to debtor countries. An obvious way in which this might be done is by buying up debt of problem debtors in the secondary market, and turning the claim over to the debtor country in exchange for a bond which is tailored to have a long maturity and a pattern of interest disbursements which helps support the country's adjustment program.

Richard Weinert has suggested a way of using the secondary market combined with government guarantees for debt relief. Here a sponsoring agency, the World Bank or the U.S. government, would issue its own debt and exchange it with a bank for a claim on an LDC on a dollar for dollar face value basis. But the sponsor's bond would carry a lower interest rate and as a result the market value, as opposed to face value, would reflect the difference between this interest rate and the market rate for U.S. Treasury bills. The size of the interest rate reduction would be such that the present value of the bond carries a discount equal to the market discount. Banks who agree to the swap do take a loss on the interest rate in acquiring a risk-free government bond in place of a doubtful LDC bond. The sponsor in turn converts the debt acquired from the banks into a claim on the LDC which exactly matches the bond issued to the bank.

One important complication of the scheme is that the discount in the market reflects not only the inability to pay, but also unwillingness. It is essential therefore, as emphasized by Weinert, that the implementation be

conditioned on adjustment programs and, indeed, serve as incentive for such programs. In this manner countries whose debts trade at the largest discounts--Bolivia or Peru, for example-- would get the maximum of debt relief. In this swap arrangement the sponsor assumes fully the default risk, the debtor gets the full benefit of the implicit bank write-off in the form of interest relief and the bank restores its balance sheet by acquiring certain low yield, safe claims in place of precarious ones. The tax payer does have exposure now because of the remaining default risk.

There is no free lunch in this scheme since the tax payer assuming the default risk is the sine qua non for the debtor to capture the full benefit of the discount. It is true, passing on to debtors debt relief in the form of lower interest rates or reduced principal reduces their debt burdens. But the debt reduction from a few billion of these swaps may not be enough to reduce default risk or the risk of payments difficulties to near-zero.

An American Fund: Among the important issues in designing the Facility is the choice between a multilateral approach, using say the World Bank, and a U.S. option. There are good arguments for the a Facility which is operated only by the U.S., with beneficiaries targeted by their importance from a perspective of U.S. foreign policy. Access to the Facility would be restricted to U.S. banks. The reason for the U.S. option is to exclude the possibility that European banks who have already fully reserved their loans should be the main beneficiaries while their governments might be the most reluctant contributors. Such a facility would also highlight the foreign policy interests of the U.S.-- in Central America and the Philippines, for example and thus stands a much better chance of Congressional approval.

Since the facility can only be effective if the government provides guarantees there is an obvious question of how much a liability tax payers are willing to assume. It probably would be a good idea to target an initial plan on countries other than the major debtors--Brazil, Mexico, Venezuela and Argentina. The reason is that a given budget for guarantees-- say \$ 20 billion can make a major contribution for many small debtors like Bolivia, Ecuador or Costa Rica while it makes only a small dent in the problems of Brazil or Mexico.

The fund might set itself two major objectives: First, for very poor, small debtors all commercial bank debt should be restructured, even if that means buying up debts from foreign banks. Second, there should be a maximum possibility for small U.S. banks to exit and regulatory facilitation should make this especially easy.

What could be expected from such a fund and how much would it cost? Debts of Latin America, excepting the 4 major debtors, and of the Philippines to U.S. banks amount to \$20 billion at face value and represents about one-third of those countries' total debt. At the secondary market valuation these bank debts amount to approximately \$13 billion at the secondary market valuation. Thus for a \$13 billion government guarantee a \$7 billion or 12 percent debt reduction for problem debtors could be secured by the facility's taking over the entire stock of U.S. bank debt for the entire group of countries.

Senator SARBANES. Thank you very much.

Ms. Lissakers, it's nice to have you before the committee.

**STATEMENT OF KARIN LISSAKERS, COLUMBIA UNIVERSITY,
SCHOOL OF INTERNATIONAL AND PUBLIC AFFAIRS**

Ms. LISSAKERS. Thank you. It's particularly nice to be here before you.

I've testified a depressingly large number of times on the debt problem and it's a little hard to say something new and original because the situation, as a number of the previous speakers have pointed out, remains very bleak. Indeed, if anything, the debtor countries, if not the banks, are worse off now probably than they were in 1982.

Senator SARBANES. It may be necessary to keep repeating the perceived truths in order to wear down the opposition, rather than necessarily come with something new, but please go ahead.

SITUATION REMAINS UNSTABLE FOR DEBTOR COUNTRIES

Ms. LISSAKERS. Not only is the situation bleak now, but the situation remains extremely unstable for the debtor countries as a whole. While the banks, it's true, can each year point to at least one or two success stories and say this proves that our strategy is correct—we just need more of the same for a longer period of time—the fact is that yesterday's success story is tomorrow's disaster. Brazil is merely the latest example. Last year it was Mexico.

The fact is that the debtor countries remain extremely vulnerable to adverse changes in external economic conditions—interest rates, oil prices, industrial country growth rates, and trade policies, as well as to any misstep in their own policies.

And the United States and the major creditor countries continue to be locked into what I consider an increasingly fruitless approach to the problem, despite the very commendable efforts here on the Hill by yourself, Senator Bradley, Congressman Schumer and others, to rethink and challenge that policy.

While the Baker initiative repackaged the old policy to call for growth, which is in itself a desirable goal, things haven't worked out. Brazil grew in 1985 rapidly and even more rapidly in 1986, and then this February it had to suspend interest payments because foreign exchange reserves were depleted. What happened?

I think one of the most interesting debt items in the papers in the last month or so was an item about the Brazilian automobile industry, which is modern, substantial, and an important part of the export sector. The Financial Times reported that General Motors, Volkswagen do Brazil and Ford had closed down or limited production severely on a number of lines, and this despite booming domestic demand.

This was due to parts shortages, but not because of a lack of foreign exchange to buy imports: by law, the automobile industry is virtually self-sufficient, supplied essentially by Brazilian producers. The parts shortage was due to capacity constraints.

The current constraint on the Brazilian automobile industry and on the Brazilian economy as a whole is the result, as Professor Dornbusch pointed out, of a lack of investment since 1982. The debt

has been serviced at the expense of investment. Domestic investment has dried up and so has foreign investment in these years.

The resulting capacity limits have short-circuited the Brazilian and the Baker plan strategy of trying to grow out of the debt problem. So long as there was excess capacity in the economy, Brazil was able to meet rising domestic demand and supply the export volume needed to generate a trade surplus that would service the debt. But as the economic boom continued, stimulated by generous wage increases and a strong export sector, domestic demand gobbled up more and more of what Brazil could produce and exports fell. It's very clear from the numbers. Exports in November 1986 were 45 percent lower than in November 1985. By then the bottlenecks had become apparent. Imports at the same time showed a slight decrease of 7 percent. It was clearly a production problem rather than a product availability problem—rather than excess imports.

There's no question that the Sarney government mishandled policy last year, operating on a political calendar rather than in an economic timeframe, and let wages and prices get badly out of line. But it's probable that even with better policies in Brazil, the underlying capacity constraints in the economy would have made themselves felt sooner or later under the current debt management regime.

That regime is premised on the assumption that commercial banks are going to be the future suppliers of large capital flows to these countries. "Keep the banks happy," the debtors are told, and "eventually soon you can come back to market." Debt relief is rejected out of hand by those who set that policy specifically on the grounds that this would cause banks to turn away from the debtor countries for decades to come.

But the "return to voluntary lending," as Professor Dornbusch pointed out, is an absolutely false hope. It's very clear from the behavior pattern of the banks in the last 4 years that they want to get out of this. They don't want to increase their exposures. They want to decrease them. And indeed, they have been decreasing their exposures even while they participate in the forced lending exercises, offsetting an increased exposure in one sector or one country while cutting in another.

Any suggestion by bank management that this trend should be reversed would be met with a revolt by the board and by their shareholders.

So these countries are going to have to look to other sources of capital. There are other sources. Private direct investment inflows and, most importantly, the wealth these economies have the capacity to generate themselves. The problem is that there is no confidence in these economies and there can't be as long as the debt overhang remains. Every investor looks and says,

What happens in the next industrial country recession, or worse, what happens when interest rates go up, because you have this Daemocles sword of floating interest rates hanging over their heads?

DEBT STRATEGY NOT WORKING

The current debt strategy does not resolve that issue. I doubt that any strategy that doesn't include some form of debt relief can.

By that I mean, as you have suggested, a reduction in the banks' claims and passing on the benefits of reduction in those claims which both reduces the outstanding debt and the debt servicing burden, a write-down by the banks and the passing on of those benefits, of the discounts, to the debtor countries.

I think there are market mechanisms and an increasing willingness on the part of the banks to contemplate different policies. The banking community I think is very, very divided. Everyone is waiting for the policy change in Washington. The real resistance to any discussion of debt relief I think is at the Fed and at the Treasury and I think the Congress can play a very important role in changing both that attitude and in suggesting mechanisms such as the discounting facility you have proposed to resolve the problem.

Keeping the debtors on a short leash solves nothing at this point. It's time to give debtors some breathing space, even room to make mistakes. The Latin countries know that reforms have to be made and some have been made indeed, but those internal reforms will make no difference unless the debt overhang can be decreased and that problem resolved.

Thank you very much.

[The complete statement of Karin Lissakers follows.]

These numbers seem very disappointing: the budget commitment in terms of guarantees is large and the debt relief seems almost negligible. But one can look at it in another way. Bolivia's external bank debt is \$1.7 billion and trades at only 13 cents on the dollar. For a guarantee on less than \$200 million there can be an altogether dramatic reduction in the external debt pressure for Bolivia. The reality of a Fund lies somewhere between those two extremes. If the access rules are well-structured a relatively small guarantee commitment can in fact buy an astounding turn in the external outlook for a host of small countries, and small banks, which are now caught by lack of a solution. There is another reason why the facility is more important than the 12 percent debt reduction suggests. The reason is that bank debt carries far higher interest rates than official debt. Thus a 35 percent reduction in bank debt reduces the total flow of interest obligations by perhaps as much as 20 percent.

The government budget would have to absorb the contingent liability involved in underwriting the bonds issued by the Fund but serviced by the income from LDC debts. If default should occur the government would have to assume debt service. Such a guarantee used to be given quite freely by the Federal government, but is now harder to extract from Congress and is subject to appropriation. The scheme, if it were operated by the U.S. government would therefore have to pass through the full rigor of Congressional budget action.

There are, of course, other possibilities. One obvious direction is to use the World Bank capital as a means of guaranteeing debt. Other possibilities focus on industrial countries with strong currencies and external surpluses. Many observers have looked to Japan as a candidate for assuming the guarantees.

A Special Role for the Facility: We have discussed here how a facility can use the secondary market as a way of intermediating between banks who want to get out and countries who cannot pay off. But there is, of course, also the possibility of joining with the Fund's resources in a restructuring agreement. An interesting feature of such a facility is that it would introduce a new party into debt negotiations. Concerned with the solvency and productivity of the facility the management would potentially take positions in rescheduling agreements to assure that the value of the assets it carries is not impaired by extortionary settlements or unreasonable adjustment programs. One might imagine, in a particular situation, that the facility makes available a long term reconstruction loan to a particular country. In exchange for participating in the financing it secures from the banks extraordinary reductions in spreads or maturities. Of course, to perform this function aggressively would require that the manager of the facility be of sufficient stature and independence to be beyond the immediate reach of the U.S. Treasury.

The bottom line on securitization or the use of a facility remains the participation of tax payers' capital. This may be far removed from sight, accomplished by World Bank borrowing, or it may be as close to the front page as pressure on Japan to do something. But unless the tax payer in some incarnation takes over the default risk the debtors cannot get the full

advantage of any discounts at which the debts are traded now.

THE CASE FOR UNILATERAL ACTION

The obstacle to organized debt relief comes from the fact that tax payers are unwilling to underwrite debtor country growth and politicians are reluctant to confront the banks, even if the case is compelling. Our banks are reluctant to consider write-offs as long as there is no outright crisis of default and even then they would prefer to see whether someone else might pick up the tab. And no one can blame the banks for that. In the meantime, debt problem proceeds with frequent reschedulings, uncertainties, and a pervasive deterioration of economic and social conditions in the debtor countries. The problem poses itself quite concretely for Brazil and, following the February 20th moratorium, the question is how Brazil will normalize its relations with the creditors.

The most likely course is for Brazil to announce, unilaterally, the amount of interest automatically capitalized, the form in which creditors can manage the capitalized portion and the applicable rates. But there are two reasons to shy away from the unilateral course. One is the threat of sanctions, the other is the possibility that the international financial system is in fact already moving in the direction of change, offering the perspective of a significantly different debt process in the near future.

It would be difficult for a debtor to find evidence of officially sponsored changes in the debt strategy. Internationally debt has made only a minor appearance at the summit meetings. The summits have been confined to reiterating the belief of the heads of state that solutions to the debt problem must follow a case-by-case approach and that adjustment of debtor countries and a favorable international climate are essential elements of a debt strategy that continues to be viewed as successful. Hence on an international level debt is simply a non-issue.

The U.S. the administration has very strongly endorsed the view that debt problems must be handled on a case-by-case approach, with market-friendly adjustment programs as the chief vehicle for improvement. Any changes in the debt strategy, except for the rhetoric of the Baker plan, have been repeatedly rejected. Assistant Secretary of the Treasury David Mulford told the House Banking Committee in March 1987:

"That is not our policy to engage in forgiveness of debt nor to encourage the international financial institutions to engage in forgiveness of debt which we think adverse for many of the reasons I've already explained.....the problem with debt forgiveness, whatever form it takes, whether it is done by the banks under one plan or by the international financial institutions or by the creditor governments, there is I think a common problem, and that is that the act of forgiveness while it produces short-term relief, very short-term relief, in the near term, immediately, in fact is more than offset by the diminution of future financing resources that are willing to flow to those countries.....We believe that the debts are collectible and that the basis on which one must proceed is that the debts will be paid."

One must conclude from this limited review that there is no imminent

change on the horizon. Even if Congressional discussion of the Bradley Plan and the Facility is encouraging, few believe that in the next two years any concrete measures of debt consolidation can be anticipated.

The scope for sanctions to be imposed on debtor countries is poorly understood. The realistic view must be that when the chips are down there is very little that can be done to a country like Brazil. The overwhelming U.S. political and economic interests dictate that a responsible unilateral action would be accepted and quietly welcomed. We discuss below what responsible action might mean.

A further issue is whether a debtor country which adopts a unilateral action, by that very fact, excludes the possibility of a future return to the world capital market. In one sense the answer is quite obvious: all of Latin America adopted unilateral action, ranging from moratoria to outright defaults, in the 1930s. None paid more than 50 cent on the dollar and yet all returned to voluntary borrowing. In fact Latin American countries, as we saw before, have not only defaulted once but many times. Thus there is little reason to accept a categorical assertion that there is no credit again after unilateral action. But it is equally important to recognize that the imminent return to voluntary lending is a myth.

Responsible Unilateral Action: A solution to the debt problem is unlikely to emerge until a major debtor, with calm and responsibility, defines unilaterally the terms of debt consolidation it imposes on the creditors. It is essential for success, and for avoiding sanctions, that the write-offs be sufficiently limited to be acceptable, that they take place in the context of a realistic restructuring of economic policies, and that they carry some guarantee so as to significantly improve the quality of the consolidated debt. The unilateral write-off should definitely carry a provision that creditors participate in any significant improvement of the country's economic position.

What might a unilateral proposal look like? The first objective is to simplify the debt rescheduling process and the second is to reduce the debt burden. To accomplish these two tasks Brazil, to take the specific case, could announce two plans among which creditors could choose. Plan A provides debt service in dollars, but at the price of a reduction in principal and interest. Plan B maintains the principal but requires that any interest be invested in Brazil for a specified period of time.

Those banks opting for Plan A (primarily small banks one would expect) receive a 30 year negotiable dollar bond with a face value equal to 80 percent of the claims on Brazil which they surrender in exchange. The bond would carry floating rate interest at the level of the U.S. T-bill rate. The government retains the right to retire the debt at any point. Banks adopting Plan A will make some loss, although not more than is implied by the discount in the secondary market. But they would receive an easily negotiable debt instrument which ultimately would find its way into non-bank portfolios. The fact that some losses are involved in this option implies that not every bank will choose this route and that accordingly enough foreign exchange is actually available to service the bond.

Those banks opting for plan B would not suffer a reduction in

principal. But in exchange they would receive the interest payments on their dollar claims in cruzados. They could maintain these cruzados in the central bank with an exchange rate guarantee and a modest interest rate in dollars. Alternatively they could lend them in Brazil to private businesses or hold government bonds. The ability to invest would be restricted to preclude that new foreign direct investment be financed with these captive deposits or that they be remitted under the guise of repatriation of principal or dividends on previous foreign direct investment. If economic conditions turned out favorable the government would allocate a given amount of foreign exchange to liberate deposits at the central bank for payment in dollars to the creditors.

The implementation of the debt plan would be accompanied by a new economic program that removes the extreme uncertainty which is now deteriorating the economic climate. Investment would ultimately resume and the quality of the debts and of the captive deposits would improve over time.

Acceptance: How should the governments of creditor countries react to such a unilateral measure? Provided the action is limited and accompanied by positive steps to enhance the prospects for sustained growth and an ultimate ability to service the debt in dollars we should welcome the action. We should applaud and encourage measures that get the debtor countries, the banks and the world economy out of the current impasse.

In the summer of 1982 the Mexican finance minister, Mr. Silva Herzog, came to Washington to report that his country could not service its debts. In the midst of confusion and a flurry of rescue activity he received one clear message: Above all, don't do anything unilateral. Now, five years later, we have come full circle: Someone, please do something unilateral.

Subcommittee on International Finance
and Monetary Policy
Committee on Banking, Housing and Urban Affairs
United States Senate
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Testimony of Karin Lissakers
Adjunct Professor of International Affairs
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Mr. Chairman, members of the Committee. It is a pleasure to appear before you to discuss U.S. policy on the international debt problem. I have testified on debt many times since 1982. Indeed, I spoke on the subject before this committee less than a year ago, saying, among other things, that although "Banks are better off generally vis a vis the debt problem...the debtor countries are in most regards no better off or even worse off than when the crisis broke. Latin American debtors have paid out more than \$130 billion in interest, only to find themselves \$50 billion deeper in debt. "

I dare say one can just add a few billion to those figures and the statement holds today.

I also suggested that the situation remains extremely unstable: "This year it is Mexico and Egypt in crisis because of the drop in oil prices; next year if interest rates rise or the industrial economies go into a slump, it

will be Argentina and Chile; the year after, Brazil because there is a glut of orange juice on the market."

Turns out, I wasn't pessimistic enough about Brazil. But my point was, simply, that while there will be temporary signs of improvement here and there, the debtor countries as a group remain utterly vulnerable to adverse changes in the external economic environment and to any mis-step in their own policies.

It is difficult to say anything new on the subject of debt because so little has changed: the debtor countries remain deeply troubled, and we the creditor nations stay locked into our original approach to the problem, despite the commendable efforts by some in Congress to rethink the policy.

The Baker Initiative repackaged U.S. debt policy to call for growth in the debtor countries. Well, Brazil grew in 1985, and even more rapidly in 1986 --more than 6%. But in February 1987, Brazil had to suspend interest payments because its foreign exchange reserves were depleted. What happened?

Perhaps the most telling news to come out of Brazil in the last few weeks was a small item about that country's automobile industry: despite booming consumer demand, General Motors and Volkswagen do Brazil have suspended production on several assembly lines and Ford has some lines operating at 30 percent capacity, due to a lack of parts. The parts shortage is not, as one might suspect, an import problem resulting from the sudden exhaustion of Brazil's foreign exchange reserves. Local content laws require the highly modern auto industry to rely almost exclusively on domestically produced components -- 95 percent by weight and 98 percent by value.

The current constraint on the Brazilian auto industry, and on the Brazilian economy as a whole, is not lack of money to pay for imports, but the absence of investment over the four and a half years since the debt crisis began. Annual Gross Domestic Investment for Latin America as a whole was \$50 billion less in 1982 and in 1984 than at the beginning of the decade and foreign direct investment dried up. Neither has recovered. Brazilian government officials say that even in 1986, in the second year of a robust recovery, there was no significant increase in investment.

The resulting capacity limits have short-circuited the Brazilian (and Baker) strategy of trying to grow out of the debt problem. So long as there was excess capacity in the economy, Brazil was able to meet rising domestic demand and

supply the export volume needed to generate a trade surplus that would service the debt. But as the economic boom continued, stimulated initially by generous wage increases and a strong export sector, domestic demand gobbled up more and more of what Brazil could produce, and exports fell. The virtual disappearance of Brazil's trade surplus is due almost entirely to a sharp decline in exports, which were 45% lower in November 1986 than in November 1985; imports showed only a slight increase, of 7 percent, in the same period. Now domestic production can't even keep pace with domestic demand as serious bottle-necks have appeared in the auto supply and other industries. (The auto sector is also a major exporter.)

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There is no question that the Sarney government bungled, letting wages and prices get badly out of line, overheating the economy. But it is probable that even with better policies, the underlying capacity constraints in the economy would have made themselves felt sooner or later under the current debt management regime.

This policy is premised on the assumption that commercial banks will continue to be the principal source of capital for these countries in the future as they were in the 1970's. "Keep the banks happy", debtors are told, "and soon you can come back to market, i.e. banks will resume voluntary lending." Debt relief is rejected out of hand on the grounds that this would cause banks to turn away from

the debtor countries for decades to come.

But this "return to voluntary lending" is an absolutely false hope. While the last four years have seen some improvement in the capital/LDC exposure ratios of U.S. banks, the exposure remains uncomfortably large in the eyes of the stock market and of the rating agencies -- Standard and Poor's just lowered the ratings of a number of large banks specifically because of the continuing debt crisis.

The "forced lending" exercises in debt restructurings have been a shell game, with banks making sure that any increase in exposure to the public sector of a troubled debtor is off-set by a reduction in private sector exposure, or new loans to one country in Latin America are matched by lower exposure elsewhere in the region. Overall, U.S. and other large multinational banks have been gradually reducing their developing country loan portfolios since 1983. U.S. bank claims on OPEC countries (including Venezuela and Ecuador) have fallen by 27%, and claims on non-OPEC developing countries by 15%.

Any suggestion by bank management that this trend should be reversed and loan exposures in Latin America, for example, increased in the foreseeable future would, I believe, trigger an instant revolt by shareholders and boards of directors. Instead, large and small banks are increasingly concentrating on industrial country markets where technology and deregulation are creating new

opportunities for expansion and profit.

The troubled debtor countries will have to look elsewhere for new capital to support growth.

Fortunately, there are other sources, including private direct and portfolio investment -- equity markets around the world are extremely liquid and some of this could spill over into the developing countries under the right conditions. And most importantly, there is the considerable wealth the developing economies generate themselves. The private sector in Brazil and the rest of Latin America has plenty of money. The problem is that too much of it is invested abroad. Private Latin American deposits in foreign banks alone amount to some \$77 billion, and that doesn't include fiduciary accounts, foreign real estate holdings, securities and other assets for which there are no numbers. Even Brazilians, who historically have preferred to invest at home, began to take their money out last year, after the much applauded de-indexation of financial instruments under the Cruzado Plan eliminated the assurance that the real value of their domestic assets would not be eroded by inflation.

The problem is not money, but confidence. Investors can abide risk, but not uncertainty so great that the risk cannot be measured and a price put on it. Debtor countries have benefitted from four years of world-wide real, if moderate, economic growth--and falling interest rates, too.

Senator SARBANES. Thank you very much.
Mr. Quale.

STATEMENT OF ANDREW C. QUALE, JR., SIDLEY & AUSTIN, NEW YORK

Mr. QUALE. Thank you for the opportunity to appear before you, Mr. Chairman. Perhaps just in the interest of full disclosure, I will describe myself a little bit. I am a practicing lawyer with a firm called Sidley & Austin and am a professor of banking law at the University of Virginia Law School and represent both developing countries, particularly Colombia with its problems that Mr. Dornbusch mentioned, and banks.

I am going to speak on debt-equity conversions and certain of the regulatory problems impeding their use.

DEBT-EQUITY CONVERSIONS

I believe debt-equity conversions are a positive device for relieving the debt problem and should be encouraged. They provide perhaps the quickest nonconfrontational way of reducing the excess leverage which plagues the developing countries.

But there are disadvantages. Nonetheless, in spite of the disadvantages, I think on balance they clearly encourage foreign investment, attract additional investment at the margin which otherwise would not have been made, and increase investment which otherwise would have come in anyway and would bring it in sooner than otherwise would have occurred.

Most importantly, I think debt-equity conversions have aroused a strong interest in new investment in countries. Industrial companies and banks are actually looking eagerly for investment opportunities. They have brought enthusiasm and hope to a scene which generally is demoralized and jaded by the burdens of endless debt rescheduling.

Debt-equity conversions thus are an engine, in my view, for growth and, we are all agreed, growth is the only way out. How big is the market? It's very difficult to say but it is limited by a number of factors.

LIMITS TO GROWTH

First of all, the attitude of the host developing country itself toward foreign investment limits debt-equity conversions.

Second, laws and regulations in the United States limit the ability of banks, in particular to do debt-equity conversions.

Third, uncertainty as to accounting treatment is a limitation.

Fourth, the lack of availability of investment opportunities is a limitation.

And fifth, the availability of debt to be converted could be limitation, although I think the volume of debt available to be converted will expand dramatically as banks increasingly take reserves against their existing debt.

Host countries must be encouraged to permit more foreign investment and permit debt-equity conversion. How can we do this? Perhaps we can provide technical assistance to these countries, help them understand how the Chilean program has been working and

other programs that have had some success, and perhaps provide some incentives or carrots in connection with the debt rescheduling process.

How interested are banks in doing debt-equity conversion? I believe banks, since they hold the lion's share of the debt and have already made their investment, must be viewed as the principal source of debt-equity conversion funding.

At a Euromoney conference several weeks ago, there were over 400 attendees, the largest Euromoney conference ever in its history, and most of the people in attendance were bankers. Some banks have internally committed themselves to invest up to \$1 billion and more in debt-equity conversions. Others have targeted initially \$200 to \$300 million, and most are just getting their feet wet.

This is a small amount in the overall picture, but it is a beginning. Debt-equity conversions are complex, time consuming, and risky transactions, so the development will be slow.

Nonetheless, in spite of such problems, I am amazed at how banks have taken such a positive attitude toward debt-equity conversions. Many banks have set up whole new departments or task forces to undertake them.

But on top of the risks and complexities, there are numerous accounting and regulatory problems to doing debt-equity conversion. I prepared a detailed paper setting forth some of these obstacles and will try to highlight just a few of them here.

PROBLEMS OF DEBT-EQUITY CONVERSION

First, regulation K of the Federal Reserve Board basically limits a bank holding company to acquiring less than 20 percent of the voting stock of a foreign company, irrespective of what activities such company engages in. If a bank holding company wants to acquire 20 percent or more of the voting stock of an entity, that entity must engage in financial or banking-related activities.

Thus, banks can't convert debt to equity other than into passive portfolio investments unless the company is financial or banking in nature.

There is one exception to this rule under regulation K Bank holding companies may acquire voting stock, without being subjected to a percentage limitation equity in exchange for a debt previously contracted provided that such equity is acquired "in order to prevent a loss on a debt previously contracted in good faith" and provided further that such equity investment is disposed of no later than 2 years or ultimately no more than 5 years after its acquisition.

When is a particular conversion "necessary to prevent a loss?" The Fed has taken a narrow, restrictive view, insisting that the debt previously contracted exception is not available to sovereign debt. I do not think that this view is required by the law.

In contrast national banks may convert debt to equity if such conversion is reasonably necessary to protect the bank's assets. The Office of the Comptroller takes a more flexible and positive attitude than does the Fed toward permitting debt-equity conversions in the context of the "debt previously contracted" exception.

REGULATORY CHANGES

What legal or regulatory changes should this committee consider? The Fed should be encouraged to revise its restrictions under regulation K to permit equity investments in excess of 20 percent in foreign companies not engaged in banking or finance activities. The Fed should also be encouraged to permit the use of the debt previously contracted exception in correction with sovereign debt.

I understand, a proposal has been made to amend 4(c)(13) of the Bank Holding Company Act, 4(c)(13) currently permits a bank holding company to acquire shares of a company which essentially only does business outside the United States if the Fed determines that to do so would not be substantially at variance with the purposes of the Act.

The proposal would specifically permit bank holding companies to acquire equity stock in connection with a conversion of LDC debt provided that the country in question has been satisfying certain performance criteria and provided further that appropriate notice has been given to the Fed and the Fed has not objected, and that the shares are not held for more than 10 years or, if later, more than 5 years after the investment can be legally repatriated under the laws of the host country.

This in general is a sound proposal and I don't think it is at variance with the intention or purposes of the Bank Holding Company Act. Moreover, it is not creating a loophole through which banks will drive recklessly.

The accountants I believe will be addressing later this morning certain proposals for the accounting treatment of debt-equity conversions. They are faced with a difficult problem of determining what is the fair value of the equity received upon a conversion. I would encourage them to develop a formula which will not inevitably result in a significant write-down of equity that is received in exchange for debt.

In sum, debt-equity conversions, I believe, are a sound engine for growth for the developing countries. The regulatory and accounting treatment should not be permitted to derail this small engine before it really gets rolling.

Thank you, Mr. Chairman.

[The complete prepared statement of Andrew C. Quale, Jr. follows:]

Yet they have barely been able to stay afloat. The question every investor necessarily asks is, "What happens in the next recession? Or the next time interest rates go up, with all that floating rate debt still hanging over their heads?"

Money from the alternative investment sources, including repatriated flight capital, will not begin to flow until there is some resolution of the bank debt problem and these questions can be answered satisfactorily.

The current debt strategy does not provide the answers: I doubt any strategy that does not include some form of debt relief can. By debt relief, I mean a plan that assures a reduced and predictable debt servicing burden for an extended period of time without adding new floating rate debt to the amounts already accumulated. (This necessarily means putting a cap on future interest charges on old debt.) Relief can be provided in a number of ways: through partial debt forgiveness, substitution of debt for equity, a shift from floating to fixed rate loans, the partial payment of interest with investment notes as in the Philippines. A multilateral agency to discount and securitize the old debt could be a very useful tool in this process.

The market mechanisms for an innovative approach to the problems are available. If there are regulatory obstacles -- and I don't think they are insurmountable -- let's move them out of the way.

The key is, as the Committee recognizes, U.S. government policy because that sets the parameters for negotiations between the debtor countries and their banks. International debt policy, at least as far as it applies to Latin America and the Philippines is set in Washington, not Tokyo or London or Bonn. Although other banks have much at stake, European and Asian governments regard this issue as primarily a U.S. security and financial concern and defer to us.

At the same time, the creditors themselves -- the banks -- are badly split. The divisions now are not only between non-U.S. banks, which (with the exception of two highly exposed British banks) all along have been more willing to consider debt relief, and U.S. banks, which have not: the divisions are not just between large banks and small banks who don't want to put up new money because they have already swapped out of their exposures or taken the losses. It is my sense that even the money center banks are increasingly doubtful about the wisdom of the current policy and that a number of large U.S. banks are willing to consider some form of debt relief. Some small steps in this direction were taken in the recent Philippine and Chilean negotiations. The strongest resistance to the concept of debt relief appears now to be in the Fed and the U.S. Treasury.

Keeping the debtors on a short leash solves nothing at

this point. It is time to give the debtors some breathing space--even room to make mistakes. The Latin American governments know all too well that serious reforms have to be undertaken; some are already in place. But internal reforms will come to naught unless investors can be convinced to commit themselves for the long haul. It is time to move the debt dilemma out of its holding pattern of short-term negotiations and into a flight plan that leads somewhere.

STATEMENT OF
ANDREW C. QUALE, JR.
SIDLEY AND AUSTIN

The world is over-leveraged. The developing nations are especially so, particularly those of Latin America. But so, too, is the United States. Equity financing must be substituted for some of the excessive debt currently carried by these countries. Debt/equity conversions provide perhaps the quickest non-confrontational way of reducing such excess leverage. There are of course other ways: repudiation or forgiveness of the debt.

The advantages of debt/equity conversions are clear, but there are also some disadvantages:

1. The issuance of local currency in exchange for the external debt which is cancelled may, if not properly managed, result in monetary expansion and inflation.

2. If the host country does seek to eliminate the inflationary impact by borrowing domestically to raise the

currency needed to effect a debt/equity conversion, then the country is merely "internalizing" its debt. Some critics believe such internal debt is more burdensome and costly than external debt.

3. If the foreign investor making a new investment would have made such investment even without the benefits of the debt/equity conversion program, then the host country would have received a direct infusion of foreign exchange in payment for such investment. Instead, debt of the nation is merely cancelled, which debt may have been rescheduled over the next ten to twenty years and, conceivably, might not even be repaid then.

On balance, although some officials of debtor nations and others are having second thoughts, I firmly believe that debt/equity conversions, if properly structured, are beneficial to both the debtor nations and the investors and should be encouraged. Why? First, the debtor nations desperately need new investment in order to grow, and foreign investment can provide an important part of such new investment. Second, at the margin, debt/equity conversion programs will clearly bring in some new investment which might otherwise not be made because it materially reduces the cost to the investor of such new investment.

C Andrew C. Quale, Jr., 1987

Special Legal and Accounting Considerations

My specific task today is to focus on certain legal and accounting obstacles which may be encountered in undertaking debt/equity conversions.

U.S. Legal Obstacles to Banks' Engaging in Debt/Equity Conversions

The U.S. legal and accounting obstacles to debt/equity conversions are encountered primarily by banks (rather than industrial corporations) seeking to undertake debt/equity conversions as principals, i.e., seeking to convert debt which they hold in portfolio to equity investments in the debtor nations. The principal legal obstacles for banks are found in Regulation K of the Board of Governors of the Federal Reserve System and in the Bank Holding Company Act. Under Regulation K, in general, U.S. member banks and bank holding companies, as well as Edge corporations and agreement corporations, are limited in the investments which they may make abroad to activities which are "of a banking or financial nature and those that are necessary to carry on such activities". Reg K specifically permits such banking entities (referred to as "investors" under the regulation but which will be referred to in the following discussion of Reg K simply as "banks") to make the following direct or indirect eligible investments.

1. A bank may acquire more than 50% of the voting shares of a company (which would then become a "subsidiary" of the bank) if such company engages solely in certain "permissible activities" that are enumerated in Reg K or in such other activities that the Fed has specifically determined to be permissible. If the company in question is a going concern, up to 5% of its assets or revenues do not have to qualify as permissible activities.

2. A bank may invest in a joint venture (which is defined as an entity of which 20% or more of the voting stock is held by the bank), provided that not more than 10% of the joint venture's assets or revenues are attributable to non-permissible activities.

3. A bank may make portfolio investments (i.e. investments in entities in which the bank holds less than 20% of the voting stock) provided that the total of the bank's portfolio investments of this type does not at any time exceed 100% of the bank's capital plus surplus. Needless to say, this could be a large number and presents a significant opportunity for most banks or bank holding companies.

To summarize, a bank or bank holding company may:

- a) acquire more than 50% of the voting stock of a foreign entity (a subsidiary investment),

provided that at least 95% of such entity's assets or revenues relate to permissible activities that are enumerated in Reg F;

b) acquire between 20% and 50% of the voting stock of a foreign company (a joint venture investment) provided that at least 90% of the assets or revenues of such company relate to permissible activities;

c) acquire a "portfolio investment" in any company irrespective of what activities the company engages in provided that such stock represents

(i) less than 20% of the voting stock of the company; and

(ii) the aggregate amount of all such portfolio investments by the bank does not exceed the bank's capital plus surplus.

Assuming that a bank's proposed investment fits within one of the foregoing categories, no prior notice need be given to the Fed of the proposed investment nor must any specific consent be obtained from the Fed if the investment

in such entity does not exceed the lesser of \$15 million or 5% of the bank's capital plus surplus. Thus, if an investment in a subsidiary, joint venture company or a portfolio company is otherwise permitted, no specific consent or notice is required provided that such investment does not exceed the lesser of such two amounts.

If a bank wants to acquire 20% or more of the voting stock of a company, the company must be engaged in "permissible activities". What are "permissible activities?" They include:

- (1) commercial and other banking activities;
- (2) commercial and consumer finance;
- (3) lease financing;
- (4) providing investment, financial or economic advisory services;
- (5) data processing;
- (6) managing a mutual fund which does not exercise managerial control over the firms in which it invests;

- (7) management consulting;
- (8) underwriting or distributing securities outside the United States; and
- (9) activities which the Fed has determined to be closely related to banking under section 4(c)(8) of the Bank Holding Company Act.

So, what if you want to invest in a tourism hotel or a steel mill? Is it a permitted activity? Clearly, not. Would the Fed be likely to grant specific consent on the ground that it is of a banking or financial nature? Clearly, not.

Then how much of the voting stock of such a company can a bank or bank holding company own? Basically, less than 20%.

A portfolio investment is permitted only if the company in which the investment is made does not have significant business activities in the U.S. If it does, then the investment is not permitted by Reg K. Are you then out of luck? No. Under the Bank Holding Company Act, a bank or bank holding company is permitted to hold up to, but not including, 5% of the voting stock of any company, wherever its activities are conducted.

If a bank wants to own more than 20% of the voting stock of a company which is not engaged in a permitted activity, what can it do? First a bank could acquire additional stock, such as preferred stock, provided that it was non-voting. How much additional non-voting stock can be acquired without running afoul of the Fed is not entirely clear, but it will depend upon what other contractual arrangements the bank has with the company, whether such non-voting stock is convertible into voting stock, the extent to which the bank might be able to exercise some degree of control over the company's operations, etc. (These are the types of issues raised in the Fed's "Policy Statement on Non-Voting Investments by Bank Holding Companies," to which the Fed says it would look for guidance in this area as well.)

Depending upon such factors as noted above, a bank might hold up to, say, 19.9% of the voting stock and, arguably, an additional 30 percent or more of the company's equity, provided that it is not voting stock. The Fed staff, however, is prepared to say that a "safe haven" is assured only if total equity (both voting and non-voting) does not exceed 25%.

There exists one exception to the basic limitations of Reg K which would permit a bank to acquire up to 100% of the voting stock of a company. Pursuant to this exception,

equity interests acquired in exchange for "debts previously contracted" are not subject to the limitations of Reg K provided that:

(1) such equity is acquired in order to "prevent a loss on a debt previously contracted in good faith"; and

(ii) such equity interests are disposed of no later than two years after their acquisition (which may be extended to a total of five years if the Board so authorizes).

Whether such exception is available will depend upon the facts of the particular case. Generally speaking, this provision has been used to permit the conversion of debt into equity of the same debtor or into equity which served as collateral for the debt in question. But, the language of the Reg does not preclude a conversion into equity of a third party.

When is a particular conversion necessary to "prevent a loss"? The Fed has taken a narrow, restrictive view, insisting that the DPC exception is not available to sovereign debt. I do not think this view is required by the applicable statute. If the bank's alternative were to hold onto the debt and, if it did, the bank would not be required by its auditors or supervisory authorities to write such debt

down and if it were not planning to do so in the ordinary course, and if the ability of the debtor to service its debt in the future is assured, then arguably the conversion of the debt to equity would not be necessary to prevent a loss. However, if the bank's alternative were to sell the debt or swap it for other debt, under these circumstances it would incur a loss or write-down and then, arguably, the conversion would be necessary to prevent a loss.

However, if, as some accountants have been proposing, the bank is required to write down the equity interest received to the "fair value" of the debt given in exchange, then the conversion will not have prevented a loss and, therefore, the bank may be denied the opportunity of using this "debt previously contracted" exception. It would be ironic that such accounting treatment, by forcing the banks to take a loss on a debt/equity conversion, would prevent the banks from being able to take advantage of the "debt previously contracted" exception.

Assuming that the Fed will not permit use of the "DPC" exception, however, all is not lost. Banks may convert debt to equity, directly, rather than holding the equity in their bank holding company. Thus, the Comptroller of the Currency will permit National banks to convert debt to equity if such conversion is reasonably necessary to protect the bank's asset. Indeed, the office of the Comptroller is

prepared to be particularly lenient and flexible in the context of the international debt crisis.

Similarly, the New York State Banking Department takes a flexible attitude in permitting the acquisition of stock for a debt previously contracted. If the bank reasonably believes the acquisition of equity in exchange for debt is necessary in order to minimize or avoid a loss in connection with a loan, and the transaction is not a subterfuge, the Banking Department will not object.

Can the banks expect some flexibility from the Fed in applying the provisions of Reg K so as to facilitate debt/equity conversions? Formally, the Fed has taken the position that the provisions of Reg K will be applied to an equity investment acquired through a debt/equity conversion in the same fashion as to any other investment. Nonetheless, in light of the strong support for debt/equity conversions from the Departments of State and Treasury, and the gradually more positive interest the Fed is showing in these transactions, perhaps some flexibility can be hoped for from the Fed. Indeed, I personally think the Fed should allow the "debt previously contracted" exception to be used to permit debt/equity conversions and to extend the permitted holding period for investments acquired pursuant to such exception. Additionally, the Fed and, if necessary, the Congress should provide for a new exception which would permit banks, in the

limited context of the international debt crisis, to convert debt to majority equity interests in companies that are not engaged only in banking or financial matters. Such steps would be clear evidence of the U.S. government's willingness to take concrete steps to help implement the Baker Plan.

Certain U.S. Accounting Obstacles

Considerable uncertainty and controversy exist concerning the proper accounting treatment for a debt/equity conversion. The Banking Committee and the Foreign Loan Subcommittee of the American Institute of Certified Public Accountants ("AICPA") have been examining for some time this issue and one of the proposals under consideration was that an equity interest received in exchange for debt should be accounted for at the fair value of the debt given up. Such treatment would, of course, require in most instances the immediate write down of the equity received upon the conversion. Such accounting treatment would severely dampen, if not kill, the desire of banks to convert debt to equity. In 1985, similarly harsh treatment by the AICPA and the Comptroller of the Currency of debt-for-debt swaps effectively terminated the market, among banks, for debt-for-debt swaps. At that time, the AICPA and the Comptroller determined that in a debt-for-debt swap the debt received should be accounted for at the current fair value of the

asset received, even if the asset given up had been accounted for at par or face value on the bank's books.

Although the AICPA committees are still deliberating this question, the chairman of its Foreign Loan Subcommittee stated before the House of Representatives Subcommittee on International Finance, on March 10, that, in his view, debt/equity swaps are exchange transactions which should be accounted for at fair value, i.e., the equity received should be booked at its "fair value". He indicated that to determine fair value it would not be appropriate to look only at the secondary market price of the LDC debt given in exchange, but that one should also look at the appraised fair value of the equity received. He suggested that an independent appraisal of the equity investment should be obtained and that this appraisal should assess not only the fair value of the equity in local currency, but also in U.S. dollars. The purpose of this latter appraisal is to take account of any restrictions on the convertibility of the asset to U.S. dollars. He notes that if the investment received had a significant value, the swap should not result in a significant loss.

I understand that a strong consensus of the members of the AICPA Committee supports a substantially similar proposal. In practice, will this proposed treatment require more than an insignificant write down of the value of the

equity asset received? If the "fair value" of such equity must take into account the secondary market value of the debt given up, as well as the U.S. dollar value of a local currency-denominated equity interest which cannot be readily convertible into hard currency, I fear that more than an insignificant loss will result. If so, many banks will be discouraged from undertaking debt/equity conversions.

Legal Obstacles Presented by Debtor Nations to Debt/Equity Conversions

Banks, as well as industrial companies, seeking to do debt/equity conversions will also encounter obstacles from the host country itself, even if it has a formal debt/equity program. Restrictions exist in many debtor countries on foreigners acquiring a controlling interest in domestic enterprises, especially in certain sensitive sectors, such as the financial sector. However, throughout Latin America a momentum is developing to lessen such restrictions. For example, in Mexico, although no formal changes in the laws or regulations have been made, nonetheless, the National Foreign Investment Commission has been more flexible and the ancillary restrictions or commitments that previously were imposed as a condition to obtaining foreign investment approvals have been eliminated or lessened. Ecuador and Venezuela have also relaxed their restrictions on foreign investment.

The financial sector in most Latin American countries is severely under-capitalized and desperately needs foreign investment. The awareness of this need is causing some governments to open such sectors to greater foreign investment in spite of the politically sensitive nature of the sector. For example, the Colombian Government, which has not been active to date in debt/equity arrangements, has proposed legislation which would permit foreign banks to acquire controlling interests in domestic financial institutions.

Some Suggestions for Structuring Equity Investments

In order to avoid some of the restrictions placed upon U.S. banks by Reg K and the BHCA to acquiring voting stock of non banking or financial entities and to avoid the restrictions imposed by certain debtor nations on foreign investment generally, investors will need to consider some creative structuring techniques. One such technique would be the judicious use of non-voting preferred stock, which would avoid certain of the restrictions on voting stock.

How can a transaction be structured to reduce the risks inherent in an equity investment denominated in a local currency? Since the equity investments into which banks will be converting their debt will be subject to the vagaries not only of the profitability of such investments, but also the

risk of devaluation of the local currency, banks quite naturally would like to protect themselves as much as possible from both these risks. Such risks can be alleviated by using a preferred stock which has attributes similar to those of debt. To accomplish this, one or more of the following "bells and whistles" might be considered:

1. The dividends on the preferred stock could be cumulative and mandatorily payable as soon as the venture has sufficient profits.
2. A sinking fund arrangement could be established into which funds would be deposited for subsequent use in paying dividends on, and ultimately redeeming, the preferred stock.
3. The issuer of the preferred stock could be an entity within an affiliated group which could be structured so that, even if the overall venture were not profitable, the particular entity issuing the preferred stock could be the beneficiary of contractual arrangements which would assure it sufficient profitability to service the dividends due on such stock.
4. To protect against the devaluation of the local currency, it might be possible to adjust or index

the dividend and redemption payments so as to reflect inflation or changes in exchange rates. Alternatively, the preferred stock could have a bonus dividend which would compensate for losses due to devaluation.

Whether any of such arrangements will work in a particular country will depend upon local corporate laws, the regulations applicable to debt/equity conversions, and regulations affecting remittances of foreign exchange in respect of dividends.

Legal Obstacles Facing Industrial Investors

Industrial companies seeking to take advantage of the benefits of debt/equity conversions are confronted with far fewer obstacles than the banks. They are faced neither with U.S. imposed restrictions on how much they may invest or in what activities, nor with the risk that accountants will force a write-down of their newly-acquired investment. They are, of course, subject to the same type of limitations as banks in respect of host country restrictions on foreign investment. In addition, industrial companies, like banks, face the uncertainty of whether or not the host country government will have sufficient foreign exchange available to enable them to remit dividends or repatriate their capital investment. Some countries experiencing a foreign exchange

shortage may give dividend remittances a lower priority than interest payments on external debt in allocating scarce foreign exchange. Debtor countries desirous of encouraging new foreign investment instead of debt to further their economic growth should consider assuring new foreign investors that their requests for dividend remittances will be given equal priority with that of interest payments.

Banks as Minority Partners with Industrial Companies

Because banks are limited by U.S. regulations to making investments of under 20% in a company's voting stock (assuming the investments are not banking or financial in nature or are not necessary to prevent a loss on a debt previously contracted), they are logical minority partners for U.S. and other industrial companies which desire to establish or expand an operation in one of the debtor countries. By selling a minority equity interest to a bank, an industrial company can obtain outside financing in local currency (which at times may be difficult) at a relatively reasonable cost. By so doing, they can also thereby share the equity risks of investment with a minority partner with whom they feel comfortable. The banks, on the other hand, will also feel comfortable being a minority partner of an industrial company in which they have confidence and indeed with whom they may well have an existing customer relationship in the United States.

Senator SARBANES. Thank you very much.

Senator Graham, I know you have been here in and out in the morning and not had an opportunity, and I will yield to you first.

Senator GRAHAM. Mr. Chairman, I have no questions at this time.

Senator SARBANES. All right.

JAPANESE BANK AND THE CAYMAN ISLAND FACILITY

I'd like to ask about—I know, Professor Lissakers, that you have just written a piece on the Japanese banks and I'd like to ask the panel how they see this decision by the Japanese banks to create this mechanism whereby they would turn over their debts to this Cayman Island facility that they are setting up. Why don't you go first? You have written an article. You're the world's expert at the moment.

Ms. LISSAKERS. Well, I think it's a very important indication of the growing disillusionment in the banking community with the current approach.

I think it's significant because the Japanese banks are the first major lenders to voluntarily start to take a write-down on loans. In fact, the first loan they are putting in to the factoring company is a Mexican loan just when they are participating in the forced lending exercise for Mexico I understand. So they are recognizing the loss on old Mexican loans while putting up new money. It's rather interesting.

I do think it is a challenge to U.S. banks certainly who are under assault from the rating agencies and from the stock market over the fact that their Latin exposure remains so large. I don't think the Japanese will—if they are true to past behavior—get out front too far on this. I mean, it will be interesting to see just how many loans they put into this facility, but it potentially can be very significant. They have at least created an escape hatch for themselves.

As I said, in the article, of course the desirable thing would be to take the next step and to pass on the benefit of any discounting that results from this write-down on their own books—pass on that benefit to the debtor countries.

Senator SARBANES. Well, might that not be part of the scheme? I know it's not a stated part currently, but that could certainly evolve as part of the scheme.

Ms. LISSAKERS. Well, it should certainly make them more receptive to any government proposal that this be done because they've taken the loss it really doesn't matter so much to them. Except that obviously the discounting facility—the factoring facility that they would continue to own would conceivably—might have a somewhat more difficult time disposing of the paper.

Senator SARBANES. Well, once they put it all in a facility, they're in a position then, particularly if the Japanese Government at some point should be prepared to provide to underwrite or support, to use the facility in an entirely flexible way as they deal with Third World countries. In other words, they're holding the debt. They can make a decision, if not like that, fairly expeditiously.

Ms. LISSAKERS. Yes.

Senator SARBANES. They no longer have to put together all these parties, although I'm not sure with the Japanese that was always a problem that approximates the problem we have, and then they can start using it in a very effective way as it may be linked to trade or to other considerations as they deal with these debtor countries, might it not?

Ms. LISSAKERS. Yes, I think that's right. And also, my understanding is that any dividends the banks get as shareholders in the factoring company would be considered extraordinary earnings. So that their earnings projections for the year—of the bank proper—the earnings projection will not be based on an assumption that there will be a constant interest income stream from those loans. So that they will be in a much more flexible position, I would say, both to do creative things with loans and to absorb any future losses.

Senator SARBANES. Do you want to comment?

TAX SHELTER AND FEE BUSINESS

Mr. DORNBUSCH. I believe the interpretation of this new Japanese institution is widely exaggerated. I think the chief advantage was as a tax shelter and as a first step for Japanese banks into the growing fee business that is associated with debt-equity swaps. The great excitement about debt-equity swaps is that it is a business for the organization that brings together an industrial investor and a small bank that wants to get out. When Nissan, the Japanese car manufacturer, invested in Mexico with a debt-equity swap, that was done by New York banks and I think the Japanese banks reacted and said "We could have picked up that business. Let's get ourselves a facility for it." And the tax laws facilitated for Japanese banks setting one up. That has happened.

Now if it grows, the next step is a way of saving on airline tickets for rescheduling trips and only at the very far horizon is it a way for the Japanese Government to drop in \$3 or \$4 billion when it's convenient. But it's mostly a tax shelter and fee business.

Ms. LISSAKERS. Could I just comment? It's true that it was structured in such a way that the banks could take a full tax deduction on the loss. But the fact is that in the process of moving these loans from the left pocket to the right pocket of the bank they have written them down through this facility. And that's what is significant.

Senator SARBANES. Mr. Quale, what about the safety and soundness arguments with respect to the banks? I take it your proposal is to ease the restrictions so that the banks themselves could do the debt-equity swaps and then hold the equity, instead of holding the debt. Is that correct?

QUESTION OF SAFETY AND SOUNDNESS

Mr. QUALE. That's correct. The safety and soundness question I think is not likely to present problems for several reasons.

First, the total amount of equity that banks can gradually invest in through a debt-equity conversion is not going to be great initially. It takes time. There are risks associated with any equity investment which have to be evaluated. But at the same time, those risks

are probably less great than the risks of holding onto the debt in the first place.

So, I don't think you will see a rush of banks to make enormous amounts of equity investments overseas, but it will simply be a question of comparing the value of sitting on essentially moribund debt to exchanging it for an equity investment that the banks believe has greater potential over the long term.

Senator SARBANES. Well, you at a minimum would retain the restriction that it be previously incurred debt in good faith, I take it?

Mr. QUALE. Yes, but I would recommend that the Fed be more flexible in how they interpret under what circumstances that exception would apply.

The Fed currently takes the position that that exception does not apply to debt-equity conversions in the context of sovereign debt.

Senator SARBANES. And you would have the Fed change that?

Mr. QUALE. I think they have the ability within their own powers and authority to interpret it more flexibly.

Senator SARBANES. Do any of the other panel members have a view on this issue?

Ms. LISSAKERS. Well, just a comment. It's possible to set up an intermediary step that gets around the limitations on equity ownership. Shearson Lehman, for example, is about to establish a venture capital fund for the Philippines in which they will buy debt from the banks; the banks will in turn get shares in this investment fund; and the investment fund will then look around for peso-denominated projects in the Philippines and the pesos will be bought with the loans.

So that they act as sort of an intermediary holder of the debt. The banks—well, the fund would collect the interest payment from the Philippines so there wouldn't be an immediate benefit to the debtor in terms of debt servicing burden. The fund would, of course, then take a management fee which I understand exceeds the spread on the current loans and pass on the remainder to the banks until this equity conversion takes place. But there are mechanisms that the market is slowly developing for getting around some of the limitations in the regulations.

I think really the problem is one of time, as Senator Bradley said. You have political realities pressing and the enormous cost to our own economy of dragging this process out very slowly. Over time the market probably will find a way to get around this, but at an enormous price.

Senator SARBANES. What about the politics of debt-equity conversion in terms of the reaction in the debtor country to this transformation of debt and equity?

The point was made this morning that the Mexican oil reserves are worth a lot of money. If you want to do some conversion in that area, there are probably a lot of people who would be very interested in it. But it doesn't seem to me that's very feasible in any political sense, given the importance that the Mexicans attach to that resource just in a national sense, and the same thing exists in other countries as well.

Mr. QUALE. I think it's not so large a problem as people are thinking. There's a substantial movement in Latin America today to permitting greater foreign investment and it is in fact essential-

ly dismantling its rules and restrictions on foreign investment. On the other hand, high-profile, very politically sensitive industries cannot easily be converted and I'm not sure any bank or any company would want to get into one of those industries. But clearly, for example, in many countries the financial sector is severely undercapitalized and these countries are looking for foreign investment to enable those sectors to be recapitalized.

It should be recognized that political leaders in the opposition may raise questions about selling off the assets of their country to foreign investors, but I think most of the thoughtful economic advisers and people in senior positions in these governments are looking for ways to encourage foreign investment.

Mr. DORNBUSCH. It's certainly correct that Americans are interested in foreign investment but none of the countries in Latin America thinks that debt-equity swaps with public sector debt is anything but a ripoff. The reason is that any debt-equity swap merely means external dollar debt replaced by domestic peso debt. The peso debt carries higher interest rates. Hence, debt-equity swaps with public sector debt immediately worsens the budget deficit.

So their advertisement as such looks good, but they are very expensive. When the Government wants investment, they can subsidize it. What they do here is subsidize investment by foreigners against domestic investment. Domestic firms will be crowded out. Foreign firms come in. That is sensitive if it was done on any scale. It's sensitive in itself because it causes a budget deficit.

FINANCING FOREIGN INVESTMENT

The second problem is debt-equity swaps mean that they are primarily financing investment from abroad which would have taken place anyway. I understand a witness is not appearing here because he has found a potential investor who was going anyway into a foreign country, he's hounded him down and said, "I have cheap pesos that I can get you through a debt-equity swap. Don't go in by yourself. Go through the secondary market."

It means the government does not receive dollars which could have been used to liberalize imports. Those dollars are used to pay off debt.

Those are the two big problems that any Latin American Government—Mexico, Brazil and Argentina in particular—see in debt-equity swaps. The Argentineans have gone out of their way to keep them small to avoid the budget problems and the Mexicans have found that dollar for dollar debt-equity swaps have been matched by a decline in direct foreign investment, meaning it's one-for-one investment which would have taken place anyway and instead went through the back door and cost the treasury extra money.

I have no doubt that there will be an investment which would not have taken place, an investment which comes 2 years earlier, that is desirable, but it's not free. It's very, very expensive. So it will not be a solution to the debt problem because it is simply too expensive on the debtor countries on the budget, on foreign exchange receipts, and if it were big, on the politics.

Senator SARBANES. Do any of the other two want to comment on that?

Ms. LISSAKERS. No. I basically think one has to temper one's enthusiasm for this process precisely because there are underlying difficulties and expenses. It's not only a plus.

Mr. QUALE. I would disagree with most of what has been said.

First, the volume of this activity is not so great that we have to worry that these countries are being overwhelmed with additional inflationary pressures. These inflationary pressures, the expansion of the money supply, can be controlled I think. And to the extent conversions create monetary expansion, it is hopefully resulting in new productive investment. Much of the monetary expansion in certain countries, in contrast, does not create productive investment.

Second, do debt-equity conversions result in new investment? I would hasten to guess that almost all debt-equity conversions done by banks or proposed to be done by banks are going to be new investments or they wouldn't be making these investments in the first place.

Moreover, with respect to investments by industrial companies, the people that I have spoken with who have actually made these investments have said,

We wouldn't go in if we thought the country was a disaster or the opportunities were terrible, but we wouldn't have necessarily gone in now. We would have waited 1 or 2 or 3 years and we would have gone in with substantially less investment than we have.

Senator SARBANES. Well, that may be. My reaction to that is that you've got sort of a Hobson's choice. Some people are holding out debt-equity swaps as really the thing to do and that's really the way we're going to address this problem. I take it, Mr. Quale, by your reaction to that, by your own admission, the volume is not going to be very great. So the problems that would come from using it as the main reliance you say won't come because it's not going to be a very big part of the picture, and that may be. And that eases the concern about the problems.

On the other hand, it immediately makes it marginal rather than central in terms of trying to address the debt problem.

So you may be right. I don't see in your response an answer, though, to the—I mean, your response to the criticism is that it's not going to be a very big part of the situation, therefore this problem is not going to be very great, and that may be true and that's fine. Perhaps that's fine. It can be sort of marginal, but then it doesn't really address our debt problem. We have to address the debt problem somewhere else.

Mr. QUALE. Yes. I think the volume cannot solve the problem. What debt-equity conversion can do, however, is create new interest and create some incremental foreign investment as well as perhaps domestic investment. And any new investment is something that's good.

Senator SARBANES. It is being prodded by some as the horse you ride in order to address this problem and to preclude considering riding other horses. So they move this one into the roadway and say this is the horse you ought to ride.

Now you're not taking that position, as I understand it.

Mr. QUALE. Absolutely not.

Senator SARBANES. Did you want to add something?

Mr. DORNBUSCH. I would like to add a remark that Congress will increasingly face the debt-equity swap lobby, first, because it's very good business; second, as small banks want to get out, they will depress the discounts in the secondary market. It's therefore essential that someone come to the other side to buy up those in the secondary market so the loans don't look so terrible. Debt-equity swaps are the only way to do it.

So we see the banking system set up new businesses—debt-equity swap businesses, which is very, very good fee business and we see them putting pressure on debtor countries to facilitate it mostly to get the fees and to push up the discounts in the secondary market.

But the economics in every debtor country is that if you don't want the monetary expansion, then you have to do an open market operation selling your bonds and the interest rate on new bonds of bad debtors is much, much higher than what they pay on the existing dollar debts. And that means much bigger budget deficits. We tell those countries to shape up their public finance and then turn around and say, "Why don't you start subsidizing the bailout of an Iowa bank?"

So I do think Congress sees a lobby. Congress does not see good economics.

Senator SARBANES. Well, I want to thank the panel very much for your very thoughtful statements which you summarized but we have the full text and we appreciate your being with us this morning and your patience in staying with us. Thank you.

If the next panel would come forward, gentlemen, unless you have amongst yourselves decided on some order I thought I would just start with Mr. Mendelowitz and move right across the panel.

STATEMENT OF ALLAN MENDELOWITZ, SENIOR ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS, GAO

Mr. MENDELOWITZ. Mr. Chairman, with your permission, I'd like to take about 7 or 8 minutes to make some summary comments and submit the full statement for the record.

We are pleased to be here today to discuss with you our observations on legislative and administrative obstacles to writedowns and swapping of LDC debt by U.S. banks.

OBJECTIVES OF STUDY

Our work, which began in January was undertaken at your request. The objectives of our work were twofold—the first objective was to determine what, if any legislative and administrative provisions may deter U.S. banks from taking such steps as writing down their LDC exposures or swapping out of high concentrations of specific country loans.

Our second objective was to explain the accounting standards pertinent to writedowns and swapping, as they play a decisive role in the presentation of LDC debt on bank financial statements.

Basically, in summary, what we found was, first, there are currently no bank legislative, regulatory, accounting or tax provisions that prevent write downs or the building of loan-loss reserves.

The legislative and administrative framework accommodates such actions, if bank management chooses to writedown a reserve for its LDC debt; however, there are regulatory, accounting and tax provisions which are perceived as disincentives by those with whom we spoke, and to the extent that these perceptions influence behavior, they serve as obstacles.

Second, write downs of debt per se have no bearing on the debt burden of the LDC's. Write downs are made for financial reporting purposes and have generally little effect on the actual obligations of borrowers. Unless a restructuring involves the outright granting of principle or interest rate concessions, there is no reduction in the burden borne by the LDC's.

The only way that an LDC would benefit if a loan was sold or swapped in the secondary market and it was eventually purchased by the LDC borrower at the reduced price prevailing in the market.

Third, according to the bank managers and others with whom we spoke, the primary obstacles to LDC debt write downs and the building of the reserves are the concerns with maintaining the strength of banks' reported earnings and balance sheets, the possible effect on bank stock values and the ability to raise capital, the continuing belief in the ultimate collectability of the LDC debt, and the fear of sending a message to LDC's that might weaken U.S. bank negotiating leverage during restructuring.

Fourth, the Tax Reform Act of 1986 requires the use of the "specific charge off" method concerning tax accounting for bad debts by banks with assets of more than \$500 million. Some bankers have cited this as a potential disincentive to early writeoff of LDC debt. They fear that individual charge-offs will now be the subject of much greater scrutiny by the IRS, and therefore, will require much more substantiation of the worthlessness of that portion of the loans written off.

Charge offs mandated by banks regulators, such as the ATRR-related charge offs are automatically accepted by the IRS. Voluntary charge offs, on the other hand, are likely to be the subject of close scrutiny, unless the bank has a certification of worthlessness from its bank regulator.

Banks supervised by the Federal Reserve are able to obtain such certifications, but banks regulated by the Office of the Comptroller of the Currency and the FDIC are not.

Fifth, the money center bankers we interviewed, cited two impediments to diversification to LDC loan portfolios. Two accounting issues reportedly discourage them from swapping their own LDC debt to improve the overall quality of their portfolios.

The first accounting concern that allegedly holds banks back from foreign loan swapping is the requirement that assets received in foreign loan swaps be valued at CFV, that is current fair value. A loss will usually be recorded even when a loan swap results in no change to the real value of a portfolio, and may even represent an improvement because of a reduction in the concentration of a specific risk.

The second accounting concern is the fear that in the future, banks would be required to "mark to market" the remaining comparable assets in the portfolio. It is feared that such an action could mean a severe decline in reported earnings for the money center banks, as well as a significant reduction in bank equity.

Sixth, the Financial Accounting Standards Board Statement 15, "Troubled Debt Restructurings" appears to be widely misunderstood as allowing banks to avoid recognizing loan losses. This is not the case, because generally accepted accounting principles require statement 15 to be used in conjunction with statement 5, which deals with assessing the collectability of loans and other related matters.

Seventh, U.S. banks have often been criticized for setting aside far less reserves than foreign banks for LDC debt. When evaluating this criticism, it should be remembered that U.S. and foreign banks operate under very different conditions. Incentives for restructurings here are to provide new loans to enable the LDC's to service their outstanding loans rather than alternatives.

OBSERVATIONS ON THE LDC DEBT CRISIS

Considering the issues developed for this hearing and integrating them with other information on the LDC debt crisis, we have the following observations.

One, the balance sheets of U.S. banks appear to overstate the real value of their LDC loans. Most of this debt is carried on the books of the banks at its historical cost or par value; however, such loans in the secondary market sell at a substantial discount from par with the actual discount varying on a country-by-country basis with the market's judgment as to the relative strength of each country.

Two, banks are not providing nor are they required to provide certain information necessary to policymakers, bank regulators, and investors on how the LDC debt crisis is affecting banks' financial conditions.

The extent to which the book value of a bank's LDC loan portfolio overstates the real value of these assets depends on the extent to which reserves have been built up for this LDC debt; however, banks do not provide total international or total LDC reserve information in reports to regulators or in bank financial statements.

In addition, on their income statements, U.S. banks generally only provide a provision for total loan loss and do not identify amounts related to LDC or other international loans. It would be useful to policymakers, regulators, and investors if banks made this information available.

Third, over the past 5 years, the costs of the LDC debt crisis has been borne in large part by the real side of the economy in both the United States and the LDC's rather than the financial sector. It appears to us that U.S. commercial banks, as a whole, have not reserved against or written down a lot of their LDC debt. As a result, their balance sheets and income statements have not been substantially affected; however, U.S. companies have lost export sales, as debt burdened LDC's restricted imports to conserve scarce hard currency.

And furthermore, U.S. companies that compete with imported goods have lost sales, as the LDC's expanded their exports to the United States to earn dollars with which to pay debt service obligations.

We estimate that the LDC debt crisis accounts for between \$12 billion and \$24 billion of the increase in the U.S. trade deficit since 1981.

In the LDC's themselves, restrictive economic policies led to recessions and a substantial decline in living standards. For example, in a recent review of U.S. participation in Mexico's Maquiladora Program, we found that successive devaluations of the peso since 1982 cut the value of the minimum Mexican wage in half from about \$8.50 a day to \$4.50 a day.

It appears to us that more of the sharing of the cost of the debt crisis by the financial sector of the economy is appropriate.

And fourth, a number of proposals have been advanced to provide relief to LDC borrowers by granting concessions on their current loans rather than providing assistance in the form of new loans.

These proposals have included interest rate and principal concessions, and the creation of a new intermediary facility which would buy discounted LDC debt and pass the benefits of lower principal obligations on to the LDC's.

All the proposals would require complex and difficult negotiations between a large number of interested parties.

Irrespective of what approach may be tried, they all involve an explicit recognition of the fact that the actual value of the LDC loans is less than their book value.

This difference is implicitly recognized for the loans of seven countries for which special reserves or write downs are required by banking authorities. However, as we said, these loans currently account for only 2 percent of bank holdings of LDC debt. By way of example, if loan loss reserves were created based on secondary market prices, the reserves against all LDC debt would be approximately 23 times those which have been required by regulators.

A prudent first step before adopting any of the new initiatives would be for the regulators to mandate required reserves for a larger number of countries than is now the case. They have this authority under ILSA; however, because of the limited use of this authority to date, further legislation may be required. Requiring larger reserves would have several benefits.

BENEFITS OF LARGER RESERVES

The first is that banks will be in a better position to absorb any realized losses on LDC loans.

A second is that an impediment to banks diversifying their portfolios by selling LDC loans on the secondary market would be eliminated. A loan sold at a discount in the secondary market would not result in a loss on the income statement if the bank previously created sufficient reserves to absorb such a realized loss.

Third, efforts to resolve the LDC debt crisis would not be driven quite as much by concerns over maintaining bank financial state-

ments at levels that diverge from the market's assessment of their real worth.

Last, a deeper and more efficient secondary market could provide some relief for LDC's if bank loans that were sold on the secondary market found their way to debtor countries.

Mr. Chairman, this concludes my summary comments, and I will be happy to try and answer any questions you may have.

Senator SARBANES. Thank you very much, Mr. Mendelowitz, and your full statement will be included in the record.

[The complete prepared statement of Allen Mendelowitz follows:]

Perhaps a final obstacle to debt/equity conversions that deserves mention is the availability of attractive business opportunities in the debtor countries. The capacity of a developing country's capital market, its industrial base and its domestic and overseas markets are, of course, limited. However, innumerable opportunities lie untapped due to the lack of capital and managerial initiative in such countries. Because of the desperate need for capital, in particular, prices of businesses in the debtor nations are very cheap. I have been actively involved in Latin American matters for 20 years (ever since serving as an advisor to the Colombian Minister of Finance) and am firmly convinced that this is a propitious, indeed excellent, time to invest in Latin America.

It also would be wise to move quickly. Although the benefits of debt/equity conversion programs to the debtor countries are significant, the programs also have their critics. One should take advantage of these programs before they are curtailed.

Conclusion

Debt/equity conversions have brought a breath of fresh air and enthusiasm to the otherwise highly jaded debt rescheduling scene. Banks and industrial companies are actually looking with interest for new investment

opportunities in the developing nations. The debtor nations are looking more favorably at foreign investment. There are obstacles, however, both legal and accounting. If debt/equity conversions are to result in a substantial amount of new foreign investment and a meaningful reduction in the amount of outstanding debt, the banks, in particular, which hold the lion's share of the debt, must not be discouraged or prevented by either the bank regulators or the accountants from undertaking these transactions. But, the legal and accounting obstacles to debt/equity conversions can be overcome. Such obstacles need not and should not be permitted to derail this struggling engine for growth.

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LEGISLATIVE AND ADMINISTRATIVE
OBSTACLES TO WRITEDOWNS AND
SWAPPING OF LESS DEVELOPED
COUNTRY DEBT

STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss with you our observations on legislative and administrative obstacles to writedowns and swapping of less developed country (LDC) debt by the U.S. banks. Our work, which began in January, was undertaken for this Subcommittee in response to a request by Chairman Paul S. Sarbanes.

The objectives of our work are twofold: First, to determine what, if any, legislative and administrative provisions may deter U.S. banks from taking such steps as writing down their LDC exposures or swapping out of high concentrations of specific country loans. Our second objective is to explain the accounting standards pertinent to writedowns and swapping, as they play a decisive role in the presentation of LDC debt on bank financial statements.

A writedown, write-off, or charge-off refers to a reduction in the book value of an asset to bring it into agreement with its present or appraised value. For LDC debt, writedowns usually refer to adjusting that portion of debt principal deemed to be uncollectible. The discussion of obstacles to writedowns also includes consideration of impediments to building reserves for loan losses because realized losses on loans are written down against such reserves. It is important to note that a writedown on a financial statement does not per se involve forgiveness of a debtor's obligation to repay debt. Banks can be mandated to

written down LDC debt on their books, but they cannot be required to grant debt forgiveness.

Our analysis is based on a review of relevant documents and interviews conducted with officials of the Federal Reserve System, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, Department of the Treasury, the Internal Revenue Service, American Institute of Certified Public Accountants, Financial Accounting Standards Board, and bank executives, economists, attorneys, security analysts and trade association representatives.

BACKGROUND

When the LDC debt crisis erupted in 1982, the immediate objective of the United States was to avert widespread financial collapse. As the initial crisis passed, creditors, debtors, and the International Monetary Fund (IMF) began a process of protracted restructuring negotiations. The combination of restructuring existing loans, infusions of new funds from commercial banks and multilateral lending institutions, instituting economic reforms under IMF supervision, and world economic growth was expected to lead the LDCs out from under their burden of external debt. Today, after almost five years of painful adjustments, leaders of the major debtor nations are finding it increasingly difficult to ask their citizens to continue to comply with these economic measures. Creditors and debtors alike have been worn down by a situation that appears to have reached a breaking point for all concerned.

Brazil, which only 7 months ago was boasting large trade surpluses and appeared to be making good progress in dealing with its debt burden, recently announced an indefinite suspension of interest payments on the \$67 billion owed to private foreign lenders. Ecuador has stopped making payments on its \$8 billion debt. And, Peru has placed a unilateral ceiling on the amount of annual debt service payments it will make.

Total developing country debt currently stands at \$950 billion, with approximately \$380 billion concentrated in Latin America. Of Latin America's \$200 billion owed to foreign commercial banks, one third, or approximately \$67 billion, is owed to U.S. banks. This debt has become more concentrated in money center banks, that is the nine largest U.S. banks, as regional banks have reduced their LDC exposure significantly. As of the third quarter of 1986, the money center banks held \$41 billion in debt from the largest Latin American debtors, while the fifteen largest regional banks held \$11 billion. Another change has been a shift by all U.S. banks from holdings of LDC private commercial loans, generally considered by banks to be somewhat more risky, to sovereign or foreign government debt. Since 1983, foreign government debt rose from 38.3 to 56.5 percent of money center bank LDC holdings, while the 15 largest regionals recorded an increase of from 26 to 46 percent.

SUMMARY OF FINDINGS

1) Currently no bank legislative, regulatory, accounting or tax provisions prevent writedowns or the building of loan loss reserves. The legislative and administrative framework accommodates such actions if bank management chooses to writedown or reserve for its LDC debt. However, there are regulatory, accounting and tax provisions which are perceived as disincentives by those with whom we spoke. To the extent these perceptions influence behavior, they may serve as obstacles. Given the subjective nature of perceptions, it is not possible to substantiate the operational impact of our respondents' concerns.

2) Writedowns of debt, per se, have no bearing on the debt burden of the LDCs. Writedowns are made for financial reporting purposes and have generally little effect on the actual obligations of borrowers. Unless a restructuring involves the outright granting of principal or interest rate concessions, there is no reduction in the burden born by the LDCs. The only way that an LDC would benefit is if a loan was sold or swapped in the secondary market and eventually was purchased by the LDC borrower at the reduced price prevailing in the market.

3) According to the bank managers and others with whom we spoke, the primary obstacles to LDC debt writedowns or the building of reserves are the concerns with maintaining the strength of banks' reported earnings and the balance sheets, the possible

effect on bank stock values and the ability to raise capital, the continuing belief in the ultimate collectibility of LDC debt, and fear of sending a message to the LDCs that might weaken U.S. bank negotiating leverage during restructurings.

4) The Tax Reform Act of 1986 requires use of the "specific charge-off" method concerning tax accounting for bad debts by banks with assets of more than \$500 million. Some bankers have cited this as a potential disincentive to the early write-off of LDC debt. They fear that individual charge-offs will now be the subject of much greater scrutiny by the Internal Revenue Service (IRS), and therefore, will require much more substantiation of the worthlessness of that portion of the loans written-off. Charge-offs mandated by bank regulators, such as ATRR-related charge-offs, are automatically accepted by the IRS. Voluntary charge-offs, on the other hand, are likely to be subject to close scrutiny unless the bank has a certification of worthlessness from its bank regulator. Banks supervised by the Federal Reserve are able to obtain such certifications, while banks regulated by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are not.

5) The money center bankers we interviewed cited two impediments to diversification of LDC loan portfolios. Two accounting issues reportedly discourage them from swapping their own LDC debt to improve the overall quality of their portfolios.

Swapping can enable banks to reduce specific concentrations of LDC exposures and is one step banks can take to lower risks posed by the LDC debt problem.

The first accounting concern that allegedly holds banks back from foreign loan swapping is the requirement that assets received in foreign loan swaps be valued at current fair value (CFV). A loss will usually be recorded even when a loan swap results in no change to the real value of a portfolio, and may even represent an improvement because of a reduction in the concentration of a specific risk.

The second accounting concern is the fear that in the future banks will be required to "mark to market" the remaining comparable assets in the portfolio. It is feared that such an action could mean a severe decline in reported earnings for the money center banks as well as a significant reduction in bank equity.

6) Financial Accounting Standards Board Statement 15, "Troubled Debt Restructurings" appears to be widely misunderstood as allowing banks to avoid recognizing loan losses. This is not the case because generally accepted accounting principles (GAAP) require Statement 15 to be used in conjunction with Statement 5, which deals with assessing the collectibility of loans and other related matters. It is more difficult, however, to assess what occurs in

actual practice, since the determination of uncollectible amounts tends to be a subjective process and differs from bank to bank.

7) U.S. banks have often been criticized for setting aside far less reserves than foreign banks for LDC debt. When evaluating this criticism, it should be remembered that U.S. and foreign banks operate under very different conditions. Other countries have stiffer reserve requirements for LDC debt. However, they are often accompanied by accounting systems which permit the use of hidden reserves and the smoothing of income, less pressure from investors for short-term earnings growth, less stringent disclosure requirements, and sizeable tax deductions for loan loss provisions.

Comparative regulatory and accounting requirements also play an important role in bank LDC lending decisions. Because capitalized interest cannot be booked as current income under U.S. bank regulations, the incentive for restructuring is to provide new loans to enable the LDCs to service their outstanding loans, rather than to capitalize interest. European banks have been more willing to consider the alternative of interest capitalization as it helps to generate considerable tax savings.

ACCOUNTING FOR RESERVES AND WRITEDOWNS

A knowledge of relevant accounting procedures is key to understanding LDC debt writedowns and U.S. bank motivation to engage in such writedowns. For both domestic and international

loans, bank regulators and accountants require banks to build a cushion of reserves, also known as the allowance for loan losses, sufficient to absorb both known and probable or anticipated loan losses. The allowance for loan losses includes both asset-specific reserves and a portion set-aside to cover general loan losses. The authoritative accounting standards for reserving for credit losses is found in FASB Statement 5 "Accounting for Contingencies." According to this Statement, reserves are built up by charges to income when it is probable that an asset has been impaired and the amount of loss can be reasonably estimated. This charge to income, called the provision for loan losses, builds the allowance for loan losses on the balance sheet by the same amount. Regulatory authorities do not allow banks to build up the allowance through additions from capital or undivided profits from past periods. The requirement that the charge be made directly to current income is consistent with accounting practice. When a loan is deemed to be uncollectible in whole or in part, charge-offs are made directly against the allowance, and the loan account is reduced by the same amount. Under GAAP, both charge-offs and reserves cannot be spread over a period of years but must be recognized in the period when the determination of uncollectibility is made.

It is important to note that the income statement, and hence earnings, will be affected to the extent the allowance needs to be restored to an acceptable level through charges to income. Thus, if a bank has built up its reserves prudently and was able to

accurately anticipate future losses, the income statement should not be severely affected by charge-offs. Only large and unexpected writedowns therefore would tend to hurt bank earnings.

FASB Statement 15 "Troubled Debt Restructurings" provides the authoritative accounting framework for creditors and debtors involved in loan restructurings. Banks are required to use this Statement when they grant concessions to a debtor experiencing financial difficulties. Contrary to notions that Statement 15 is a little used accounting standard, banks involved in LDC restructurings are already using it and, in fact, are required to do so under GAAP.

The type of concession that has been most applicable to LDC debt restructurings is a modification of loan agreement terms, such as extending the maturity date of loans and granting interest rate concessions. According to this Statement, if the total expected cash payments, both principal and interest, over the modified term are less than the remaining balance on the bank books, the bank must writedown the loan by the amount of the difference. If, however, the total expected cash payments equal or exceed the remaining balance, no restructuring loss is deemed to have occurred. In effect, these provisions contribute to the use of longer work-out periods, as the longer the repayment period, the less likely the granting of concessions will result in a required writedown.

Because of this provision, Statement 15 is widely thought as allowing banks to avoid recognizing loan losses. However, GAAP requires Statement 15 to be used in conjunction with Statement 5, which deals with assessing the collectibility of the amounts due under restructuring. Thus, to the extent that the new restructured amounts are judged to be uncollectible, charges to income must be made to recognize the economic loss that has occurred. Actual practice is more difficult to assess, however, since determining uncollectible amounts is a largely subjective process and differs from bank to bank.

Accounting rules provide the framework for banks to accurately portray the value of their assets. However, in the view of some, banks are engaging in an accounting fiction by keeping LDC loans on their books at historical cost, in the face of serious doubts over the ultimate collectibility of debt principal. Present accounting standards allow for these impaired values to be shown in the statements through the allowance for loan losses. A decrease in the total value of loan assets is shown when the loan loss allowance is netted from loan receivables on the balance sheet. For example, if a bank believes that its \$100 million exposure to country X is only 70 percent collectible, it should provide \$30 million to the loan loss allowance. The aggregate loan account is then shown net of the \$30 million allowance. Given the highly judgmental process involved in setting aside loss reserves,

however, banks do tend to differ in the degree of prudence exercised in building these reserves.

DISCUSSION OF OBSTACLES/DISINCENTIVES TO WRITEDOWNS AND SWAPPING Banking Legislation

Current banking legislation does not serve as an obstacle or disincentive for banks to writedown or build reserves for their LDC debt. The International Lending Supervision Act of 1981 (ILSA) requires banks to establish special reserves, called Allocated Transfer Risk Reserves (ATRR), for those international loans which in the judgement of the bank supervisory agencies have been impaired by (1) a protracted inability of the borrowers to make payment or (2) no definite prospects for the orderly restoration of debt service. These reserves are separate from the allowance for loan losses, cannot be included in the calculation of primary capital, and must be charged against income.

Bank Regulation

Our respondents unanimously agreed that current bank supervisory regulations do not, in any way, prevent banks from writing down or reserving against their LDC debt. Rather, bank regulations provide a framework for writedowns of seriously impaired LDC debt through the special reserves required under ILSA. At least annually, the bank supervisory agencies jointly determine the ATRR or special reserves through the Interagency Country Exposure Review Committee (ICERC). ICERC places bank exposures of

monitored nations in one of seven risk categories, ranging from "strong" to "loss". Exposures classified as value-impaired require the use of special reserves, while those in the loss category must be completely written-off. A bank may choose to writedown the value of the loan instead of establishing a special reserve. The amount of the special reserve is generally initially set at 10 percent of the exposure, with additions of 15 percent in subsequent years if appropriate. As of July 1986, seven countries were included in the impaired category, representing only 2% of the total outstanding bank debt owed by the LDCs.

For non-mandated writedowns and reserves, banks have considerable leeway in determining amounts to be recognized. Banks are directed to follow the same standards used for domestic debt in evaluating their international loan portfolios. They must also classify as non-performing all loans for which interest payments are more than 90 days past due. After this 90 day period, interest income can no longer be recorded and income accrued during the 90 day grace period must be subtracted. Such loans are placed on a cash basis, where income may be accrued only as it is received in cash.

U.S. bank regulators and their European and Canadian counterparts have followed different strategies for dealing with the LDC debt problem. Regulators in other countries have focused primarily on requiring large loan loss reserves. Canadian banks, for example, have been required to set aside loan loss reserves of

20 percent of their exposure to a "basket" of 12 LDCs. In Spain, countries are grouped into risk categories: provisions of 15 percent are required for countries categorized as having temporary difficulties, and 20 percent to 90 percent for those categorized as "risk" and "considerable risk" nations. In Switzerland, some 100 countries have been grouped into three risk categories with reserve requirements ranging from 10 percent to 50 percent; Swiss regulators generally view 20 percent as the minimum rate for problem countries.

A majority of banks interviewed cited a provision of the joint-agency proposal on Risk-Adjusted Capital (Federal Reserve system, January 1987) as a potential disincentive to building reserves against loan losses. The Federal Reserve will be seeking specific comment on whether the allowance for loan losses should be eliminated in the future from the definition of primary capital. The bankers and security analysts we spoke with felt strongly that if such a proposal were to be adopted, it would have serious ramifications for banks' capital positions. The larger the loan loss reserve, the lower the level of primary capital when the reserve is subtracted. Banks which built up loan loss reserves therefore would, in effect, be penalized for increasing reserves to cover future losses. To meet minimum regulatory requirements, banks would have to restore capital levels after subtracting loan loss reserves.

Senator SARBANES. Mr. Bench.

**STATEMENT OF ROBERT BENCH, DEPUTY COMPTROLLER OF
THE CURRENCY, WASHINGTON, DC**

Mr. BENCH. Thank you, Mr. Chairman. I am pleased to have this opportunity to discuss regulatory practices affecting Third World debt. Over the past 5 years, the accounting profession and bank supervisors have worked well within the collective debt strategy. We have achieved the key objectives of more current and meaningful public disclosures by the banks, as well as significant increases in reserves and capital at the banks. Overall, I believe that no significant obstacles exist to the development of mutually beneficial new relationships between banks and the debtor countries. However, should obstacles arise, I am certain they can be overcome for prudent transactions.

I expect we shall see some enhancements to the existing relationships between the banks and debtor countries. Those relationships over the past 5 years have relied on a set of burden-sharing arrangements keyed to continual negotiations of debt rescheduling and new money packages based on hundreds of banks' exposure positions as of August 1982.

These arrangements have served the stability of the international financial system very well. They have been successful in restoring countries' liquidity and supporting economic adjustments. However, the process can involve considerable delays in finalizing vital financing agreements. While progress is now being made on a number of rescheduling and new money packages, greater flexibility in the banks' syndication process may be needed to better suit the needs of the various parties.

I wish to emphasize that any discussion about policies and practices toward new financial relationships between developing countries and their bankers must consider the policies, regulations, and practices in the developing countries. It is essential that they provide incentives for new financial arrangements, including more hospitable policies for foreign direct and equity investments. The developing countries need to promote a reasonable environment, and their own ideas for financing options, options that fit the interests of their banking partners. If the debtor countries establish those reasonable policies, I am sure more mutually beneficial relationships will develop.

As for our part, it may be time for the commercial banks to consider more of a blend of financing alternatives which would be consistent with the Program for Sustained Growth initiated by Secretary Baker. The collective support and net new financing required for LDC growth must be maintained and match the strategies of various banks and their particular national supervisory or accounting systems. Such options as repricing, retiming, or asset conversions would seem to be entirely within the existing case-by-case approach and could facilitate future reschedulings and new money arrangements.

Before I turn to the specific questions the subcommittee asked me to address, I would like to briefly discuss the general accounting and regulatory practices that we follow.

GENERAL ACCOUNTING AND REGULATORY PRACTICES

As far as the accounting and regulatory procedures for international debt are concerned, no legislative reform appears necessary. The U.S. banking agencies have authorities to establish their own regulatory accounting principles and attempt to keep it as consistent as possible with the generally accepted accounting principles [GAAP] established by our U.S. accounting profession. During the international debt crisis, GAAP has evolved due to the uniqueness of LDC debt situations. In my opinion, this evolution has gone well.

The valuation of loans, either by the accountants or the banking agencies, generally is made through the audit or examination process. Valuation is a function of perceived creditworthiness. However, as we testified during 1983 before this committee, unlike domestic loans, foreign loans contain an additional factor called transfer risk. It is the risk that foreign exchange might not be available for orderly remittance of loan payments. The banking agencies examine transfer risk through their Interagency Country Exposure Review Committee. Because this risk varies depending on a complex variety of macro and microeconomic matters, the banking agencies have found that the best way to address it is by encouraging banks with foreign loans to substantially improve their capital and loan loss reserves, as well as disclose a great deal more to the public marketplace.

I would like to turn now to the specific areas the subcommittee asked me to address in its prepared questions and highlight some important points. Detailed responses to all of the subcommittee's questions are contained in my written statement.

OTHER TRANSFER RISK PROBLEMS

First, whether a categorization of other transfer risk problems [OTRP] or value impaired is required for new loans is determined by the agencies on the basis of a country's performance.

The Federal banking agencies, pursuant to ILSA, categorize international assets as "value impaired" when a country has protracted arrears or the country shows no definite prospects for an orderly restoration of debt service in the near future.

The agencies use the category "OTRP" when there has been a disruption of payment but the country is attempting to resolve its problems.

The banking agencies may determine that one category, such as value impaired or OTRP, may apply to all loans or to only some loans. That depends on the type of facility offered. It also depends on the collateral.

Second, in terms of the regulation of international debt by other countries, we perceive that the treatment is the same as that offered by the U.S. banking agencies. However, the supervision of the countries varies in methodology, primarily due to different tax, accounting, and supervisory conventions in those countries.

At the policy level, all countries deal with the difficult paradox of balancing macro and microprudential requirements in the same way. From a macroprudential perspective, supervisors in all countries support the collective attempts to promote continued, modest additional bank lending to debtor countries. However, supervisors

in every country face the need to have microprudential requirements that banks also protect against the latent uncertainties inherent in the overall debt situation. The amounts of protection may be mandated by law or regulation, or they may be negotiated.

Generally, the debtor countries subject to reserves are the same across a wide spectrum of supervisory systems. The amounts of reserves or write offs may vary by international supervisory systems and by international banks depending on what is included in the supervisory coverage of international risk, and again, depending on tax systems or accounting systems in various countries.

When I look around at various banking systems, I believe that correct policies are in place and adequate, deliberate protection is being taken.

Third, the committee should be aware that applying the term "secondary market" to the current level of trade in LDC loans is misleading and may confuse the issues of proper valuation and accounting treatment for those loans. Well-developed secondary markets have depth and breadth and are usually supported by primary marketmakers. In the usual sense of the term, the existence of a secondary market for any asset also implies that there is some homogeneity of obligors, terms, and legal underpinnings. However, we see little of this infrastructure found in the secondary market for LDC debt and we believe that the prices currently being quoted for the LDC debt reflect these market imperfections.

In response to your fourth question, in cases where a discount from face value on a loan is passed to a borrower in terms of lower principal payments, we think the resulting reduction in a country's total debt burden should enhance the quality of the remaining outstanding loans to that country. However, it is not completely clear how regulatory or accounting practice can distinguish among discounted sales in terms of the value of the remaining unsold loans.

Finally, it should be noted that the present accounting standards for assets received in swapping of bank debt are varied. Application of the standards to swaps of foreign debt is difficult. There is not a broad established market for the assets and individual countries may impose significant restrictions on the assets received in the swap transaction.

The accounting framework for debt-equity swaps also remains unclear because many, if not most, swaps do not entail a nice clean acquisition of an equity and generally many strings bind the loan sale and equity purchase.

I do not believe, however, that the existing treatment within the accounting profession is an impediment to debt-equity transactions at this time, and we understand the profession will establish uniform, pragmatic guidance for the banking industry soon.

A significant constraint on these swap transactions at this time, we think, are the policies in the developing countries. The countries need to promote a reasonable investment and regulatory climate, as well as a supply of equity opportunities, which fit the risk tolerance and business interests of potential investors, including banks.

I would be pleased to answer any questions that you have, Mr. Chairman.

[The complete prepared statement of Robert R. Bench follows:]

Accounting

Our respondents unanimously agreed that current accounting standards do not prevent banks from writing down or reserving against their LDC debt. Most of the bankers we interviewed did feel, however, that two aspects of accounting standards serve as barriers to improving the quality of bank asset portfolios through swapping. The first is the requirement that foreign loan swaps be valued at current fair value (CFV). According to the American Institute of Certified Public Accountants' "Notice to Practitioners on Foreign Loan Swaps" (May 1985), a swap of different debtor loans represents a transaction or an exchange of monetary assets. As the earnings process is deemed to be complete at the date of the transaction, the debt received in the exchange must be valued at CFV. To the extent that the CFV of the debt received is greater or less than the recorded investment of the debt given up, a gain or loss must be immediately recognized. According to the Statement, the CFV of the loan received will generally be less than the book value of the loan swapped away, so that a loss will usually be recognized. If a bank seeks to swap \$10 million of its country X debt for \$10 million in country Y debt it must record a loss even if the debt received is equal in value to the debt swapped away. A number of banks felt strongly that the use of CFV to value the debt received results in a loss even when the swap results in no real change to the value of their portfolios.

The Statement acknowledges that the determination of CFV is a difficult and subjective process, particularly in the light of an underdeveloped secondary market for LDC debt. Therefore, this determination does not rely exclusively on secondary market indicators but also takes into consideration a basket of other factors, such as similar transactions for cash, underlying credit risk, prevailing market interest rates, and debt instruments of similar character.

The second concern expressed by bankers was the fear that if they swapped assets in their own foreign loan portfolios and wrote down the debt swapped to CFV, they might in the future be required to mark to market the remaining comparable assets in the portfolio. Marking to market refers to the writedown of debt principal to current market value. Current accounting standards provide that the remaining portion of a swapped portfolio need not be marked to market as long as recognition of a swap loss is unrelated to ultimate collectibility, and management has not demonstrated its intention to dispose of the remaining debt prior to maturity. Bankers told us they worry that as the secondary market for LDC debt becomes more standardized, accountants will be able to point to clearly identifiable values for LDC debt and marking to market will be required. The money center banks are very concerned about this, as they would have the most at stake if marking to market were to be required. Such an action could mean a severe decline in U.S. bank reported earnings. According to several officials from

the accounting profession, the fear of having to mark to market is not justified, as historical cost accounting principles permit debt of various values to sit side by side on the balance sheet. They do not foresee a change being made in this fundamental accounting tenet. Other accounting representatives felt that if the secondary market for LDC debt grew sufficiently large, accountants would have little choice but to require marking to market.

Tax

Under the Tax Reform Act of 1986, banks with assets of greater than \$500 million are required to switch from the "reserve" method to the "specific charge-off" method for tax deductions for bad debts. The "specific charge-off" method stipulates that banks can only receive tax deductions for loan losses actually charged-off. Previously, deductions were allowed for additions made to the tax bad debt reserve up to .6% of eligible loans. A number of bankers we interviewed cited this change in the tax law as a potential disincentive to the early write-off of LDC debt. They fear that individual charge-offs will be the subject of much greater scrutiny by the IRS than in the past, and will require much more substantiation of the worthlessness of that portion of the loans written-off.

A loan must be deemed worthless under IRS criteria in order for a charge-off to be accepted by the IRS as tax deductible. This criteria puts the onus on banks to prove beyond a reasonable doubt that loans are truly uncollectible. This approach, unwittingly,

appears to work at cross-purposes with the call that is made by many for banks to charge-off their LDC debt as early as possible in a prudent attempt to reduce their developing country exposure.

For tax purposes, a debt is not worthless merely because its collection is in doubt. The loan is not considered to be worthless if there is reasonable expectation that the debt may eventually be repaid. The bankers to whom we spoke are concerned that there will be protracted disputes with the IRS given the difficulty of predicting the ultimate collectibility of LDC debt. This concern has not yet been tested as most of the LDC debt charged-off to date has been mandated by the bank regulatory agencies under ICERC's ATRR requirements. Charge-offs mandated by bank regulators, such as ATRR-related charge-offs, are accepted by the IRS. The problem arises with voluntary charge-offs. The IRS will accept voluntary charge-offs as tax deductible as long as a certification of loan worthlessness is provided by bank regulatory authorities. Depending upon which Federal agency supervises a particular bank, certification may or may not be provided. Those banks supervised by the Federal Reserve are at an advantage, as they are able to obtain certifications of their loan charge-offs, while banks under the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are not provided with such letters.

Discussions with IRS officials confirmed the bankers' concern that voluntary LDC charge-offs would very likely be disallowed using IRS criteria for worthlessness. The criteria was developed

with domestic debt in mind and therefore has limited applicability to the unique characteristics of country risk. For example, according to the criteria, a creditor must have taken all reasonable steps necessary to collect a debt, including legal action if necessary, before the debt will be held to be worthless. This requirement is not appropriate to the international lending environment. Another IRS representative stated that any bank which voluntarily charged-off portions of its LDC exposure in the absence of similar charge-offs by all banks would have to go a long way to justify such actions. According to this official, the IRS, for example, would be skeptical of a bank which charged-off portions of its Mexican debt if the other parties to the Mexican loan package did not do the same. In other words, unless banks charge-off their LDC debt collectively, individual banks will be hard-pressed to prove worthlessness and claim a valid tax deduction.

RELATED OBSERVATIONS

In considering the issues raised by the banks and integrating them with other information on the LDC debt crisis we have the following observations.

1) The balance sheets of U.S. banks appear to overstate the real value of their LDC loans. Most of this debt is carried on the books of the banks at its historical cost or par value. However, such loans in the secondary market sell at a substantial discount from par, with the actual discount varying on a country by country

basis with the market's judgement as to the relative strength of each country.

2) Banks are not providing nor are they required to provide certain information necessary to policy makers, bank regulators and investors on how the LDC debt crisis is effecting banks' financial conditions.

The extent to which the book value of a bank's LDC loan portfolio overstates the real value of these assets depends on the extent to which reserves have been built for this LDC debt. However, banks do not provide total international or total LDC reserve information in reports to regulators or in bank financial statements. In addition, on their income statements U.S. banks generally only provide a provision for total loan loss, and do not identify amounts related to LDC or other international loans. It would be useful to policy makers, regulators and investors if banks made this information available.

3) Over the past five years the cost of the LDC debt crisis has been born in large part by the real side of the economy in both the United States and the LDCs rather than the financial sector. It appears to us that U.S. commercial banks as a whole have not reserved against or written down alot of their LDC debt. As a result, their balance sheets and income statements have not been substantially affected. However, U.S. companies have lost export

sales as debt burdened LDCs restricted imports to conserve scarce hard currency. Furthermore, U.S. companies that compete with imported goods have lost sales as the LDCs expanded their exports to the United States to earn dollars with which to pay debt service obligations. We estimate that the LDC debt crisis accounts for between \$12 and \$24 billion of the increase in the U.S. trade deficit since 1981. In the LDCs themselves, restrictive economic policies led to recessions and a substantial decline in living standards. For example, in a recent review of U.S. participation in Mexico's Maquiladora Program we found that successive devaluations of the Peso since 1982 cut the value of the Mexican minimum wage in half - from about eight and a half dollars a day to about four and a half dollars a day.

It appears to us that more of a sharing of the cost of the debt crisis by the financial sector of the economy is appropriate.

4) A number of proposals have been advanced to provide relief to LDC borrowers by granting concessions on their current loans rather than by providing assistance in the form of new loans. These proposals have included interest rate and principal concessions, and the creation of a new intermediary facility which would buy discounted LDC debt and pass the benefits of lower principal obligations on to the LDCs. All of the proposals would require complex and difficult negotiations between a large number of interested parties.

Irrespective of what approach may be tried, they all involve an explicit recognition of the fact that the actual value of the LDC loans is less than their book value. This difference is implicitly recognized for the loans of the seven countries for which special reserves or writedowns are required by banking authorities. However, as we have said, these loans currently account for only 2 percent of bank holdings of LDC debt. By way of example, if loan loss reserves were created based on secondary market prices, the reserves against all LDC debt would be approximately 23 times those which have been required by regulators.

A prudent first step before adopting any of the new initiatives would be for the regulators to mandate required reserves for a larger number of countries than is now the case. They have this authority under ILSA. However, because of the limited use of this authority to date, further legislation may be required.

Requiring larger reserves would have several benefits. The first is that banks will be in a better position to absorb any realized losses on LDC loans. A second is that an impediment to banks diversifying their portfolios by selling LDC loans on the secondary market would be eliminated. A loan sold at a discount in the secondary market would not result in a loss on the income statement if the bank previously created sufficient reserves to absorb such a realized loss. Third, efforts to resolve the LDC debt crisis would not be driven quite as much by concerns over

maintaining bank financial statements at levels that diverge from the market's assessment of their real worth. And lastly, a deeper and more efficient secondary market could provide relief to LDCs if bank loans that were sold to the secondary market found their way to debtor countries.

Mr. Chairman, this concludes my statement. We will be happy to try to answer any questions you may have.

Senator SARBANES. Well, thank you very much, Mr. Bench, for a very detailed statement which you have summarized. We appreciate the work that's gone into this.

Mr. BENCH. Thank you.

Senator SARBANES. Mr. Leisenring.

STATEMENT OF JAMES LEISENRING, DIRECTOR OF RESEARCH AND TECHNICAL ACTIVITIES, FINANCIAL ACCOUNTING STANDARDS BOARD, STAMFORD, CT

Mr. LEISENRING. Good afternoon, Mr. Chairman and staff. I am Jim Leisenring, director of research and technical activities of the Financial Accounting Standards Board. The FASB appreciates the opportunity to appear before the subcommittee particularly to answer your questions. My prepared remarks today, Mr. Chairman, will be very brief. The FASB submitted a written statement today to the subcommittee that addresses the subject of this testimony in much more detail.

The FASB is the designated private sector organization for establishing standards of financial reporting. FASB pronouncements apply to all business enterprises, including financial institutions, and form the primary component of generally accepted accounting principles. The term "generally accepted accounting principles" describes a body of literature and accepted practices that is designed to provide relevant, reliable, and useful information to investors, creditors, and other users of financial statements.

You have asked that I address two aspects of generally accepted accounting principles—collectibility of loans and the restructuring of debt. I would first like to talk about the collectibility of loans.

COLLECTIBILITY OF LOANS

A lender advances cash with the expectation that the future cash receipts specified by the terms of the agreement will provide a return of the amount loaned as well as a return or yield on that loan. The conditions under which loans exist frequently involve some degree of uncertainty about their collectibility. FASB statement No. 5, "Accounting for Contingencies," provides guidance on the accounting for contingencies, including collectibility of loans and other accounts receivable.

Statement 5 requires loss recognition when it is probable that an asset has been impaired and the amount of the impairment can be reasonably estimated. That assessment may be considered in relation to individual loans or in relation to groups of similar types of loans. If the conditions of statement 5 are met, loss recognition is required even though the particular loans that are uncollectible may not be specifically identifiable. If the reasonable estimation of the loss is a range, the lender must recognize a loss at least equal to the minimum amount in the range.

The assessment of the collectibility of loans involves numerous factors, including the experience of the lender, information about the ability of debtors or guarantors to pay, the current economic environment, and the value and accessibility of specific collateral or other assets of the borrower or of the guarantors. If such assessment shows that all or a portion of a loan or group of loans is un-

collectible, statement 5 requires recognition of the uncollectible portion as a loss.

The FASB certainly recognizes that the determination that all or a portion of a loan is uncollectible is not a clear-cut, objective decision, but rather is subjective and requires careful judgment. Different individuals, financial institutions or enterprises may evaluate very similar facts and come to different conclusions regarding the extent to which an asset has been impaired.

Let us now turn to what is known as troubled debt restructuring.

DEBT RESTRUCTURING

Recent testimony before various committees of this Congress as well as the 99th Congress has focused particular attention on FASB statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." Statement 15 was issued in June 1977 and since then has been applicable to banks and other parties to troubled debt restructurings in preparing financial statements in accordance with generally accepted accounting principles.

The accounting has been characterized incorrectly by some as a means for banks to avoid recognizing losses on those loans.

Restructuring a troubled loan is not an accounting technique. It is an amendment of a loan contract that changes the rights and privileges of the parties to the contract, often significantly. Statement 15 established the accounting and reporting requirements to be followed by the lender and the borrower when a troubled debt is restructured. Statement 15 also requires the lender to a troubled debt restructuring to make certain disclosures to inform users of the financial statements about the effects of the concessions granted to the borrower.

The application of statement 15 to a troubled debt restructuring does not permit a lender to ignore the issue of collectibility. That remains a separate accounting judgment that must be made pursuant to the guidance in statement 5 that I have previously discussed.

Mr. Chairman, that completes my prepared statement. I would be pleased to answer your questions.

[The complete prepared statement of the Financial Accounting Standards Board follows:]

FOR RELEASE UPON DELIVERY

APRIL 2, 1987, 9:30 AM

STATEMENT OF

ROBERT R. BENCH

DEPUTY COMPTROLLER OF THE CURRENCY

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE

AND

MONETARY POLICY

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

APRIL 2, 1987

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MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, I AM PLEASED TO HAVE THIS OPPORTUNITY TO DISCUSS REGULATORY PRACTICES AFFECTING THIRD WORLD DEBT. IN MY STATEMENT THIS MORNING, I WILL BEGIN WITH A SHORT REVIEW OF THE CURRENT FOREIGN DEBT SITUATION FACED BY U.S. BANKS. THEN, I WILL RESPOND TO THE SPECIFIC QUESTIONS IN YOUR INVITATION TO TESTIFY. FINALLY, I WOULD LIKE TO BRIEFLY DISCUSS SOME NEW DEVELOPMENTS INVOLVING U.S. BANKS AND THE HEAVILY INDEBTED COUNTRIES.

THE FOREIGN DEBT SITUATION OF U.S. BANKS

AS OF SEPTEMBER 30, 1986, 184 U.S. BANKS REPORTED HOLDING \$301 BILLION IN CROSS-BORDER, NON-LOCAL CURRENCY CLAIMS. THAT AMOUNT REPRESENTS 11% OF THE TOTAL ASSETS IN THE U.S. BANKING SYSTEM AS OF THAT DATE.

ABOUT \$100 BILLION OR ONE-THIRD OF THE LENDING HAS BEEN MADE TO DEVELOPING COUNTRIES. \$79 BILLION REPRESENTS CLAIMS ON LATIN AMERICA.

DEVELOPED COUNTRIES	\$178 BILLION	59%
OPEC & DEVELOPING COUNTRIES	110	37%
BANKING CENTERS AND		
MULTILATERAL INSTITUTIONS	9	3%
EASTERN EUROPE	4	1%
	<u>\$301 BILLION</u>	<u>100%</u>

THE LATIN AMERICAN EXPOSURES ARE CONCENTRATED IN A RELATIVELY SMALL NUMBER OF U.S. BANKS.

NINE MONEY CENTER BANKS	\$51 BILLION	64%
FOURTEEN OTHER LARGE BANKS	14	18%
161 OTHER BANKS	14	18%
	<u>\$79 BILLION</u>	<u>100%</u>

SIXTY-ONE PERCENT OF THE LENDING IS TO GOVERNMENTS OR THEIR AGENCIES, AND FORTY PERCENT IS SHORT-TERM.

FOREIGN BANKS	\$16 BILLION	20%
PRIVATE SECTOR	15	19%
GOVERNMENTS AND AGENCIES	48	61%
	<u>\$79 BILLION</u>	<u>100%</u>

UNDER ONE YEAR	\$32 BILLION	40%
ONE TO FIVE YEARS	25	32%
OVER FIVE YEARS	22	28%
	<u>\$79 BILLION</u>	<u>100%</u>

U.S. BANKS HAVE BEEN STRENGTHENING THEIR INTERNATIONAL POSITIONS STEADILY OVER TIME AND WE EXPECT THIS TREND TO CONTINUE. OVER THE PAST FIVE YEARS, PRIMARY CAPITAL (SHAREHOLDER'S EQUITY AND LOAN LOSS RESERVES) HAS RISEN \$23 BILLION IN 23 OF THE LARGEST U.S. BANKS ENGAGED IN INTERNATIONAL BANKING AND OVER \$35 BILLION IN THE CONSOLIDATED HOLDING COMPANIES OF THOSE BANKS.

AS A RESULT, EXPOSURES AS A PERCENT OF CAPITAL TO ALL DEVELOPING COUNTRIES DECREASED SINCE 1983 FROM 209% TO 147% FOR NINE MONEY CENTER BANKS AND FROM 153% TO 87% FOR THE 14 OTHER LARGE BANKS. SINCE 1983, THE NINE MONEY CENTER U.S. BANKS HAVE DECREASED THEIR LATIN AMERICAN EXPOSURE, AS A PERCENT OF CAPITAL, FROM 163% TO 114% WHILE THE 14 OTHER LARGE BANKS HAVE DECREASED THEIR VULNERABILITY IN LATIN AMERICA FROM 117% TO 65% OF CAPITAL.

THE ACCOUNTING AND REGULATORY PRACTICES FOR INTERNATIONAL DEBT

BEFORE RESPONDING TO YOUR SPECIFIC QUESTIONS ABOUT THE CURRENT ACCOUNTING AND REGULATORY POLICIES IN PLACE TO SUPERVISE THE INTERNATIONAL ACTIVITIES OF U.S. BANKS, I FIRST WOULD LIKE TO DISCUSS SOME GENERAL MATTERS.

THE U.S. BANKING AGENCIES HAVE AUTHORITIES TO ESTABLISH THEIR OWN REGULATORY ACCOUNTING PRINCIPLES ("RAP") AND NO FURTHER LEGISLATION APPEARS NECESSARY IN THIS AREA. AS A MATTER OF POLICY, THE AGENCIES PREFER THAT RAP BE AS CONSISTENT AS POSSIBLE WITH THE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ("GAAP") ESTABLISHED BY OUR U.S. ACCOUNTING PROFESSION. DURING THE INTERNATIONAL DEBT CRISIS, GAAP HAS EVOLVED DUE TO THE UNIQUENESS OF LDC DEBT SITUATIONS. IN MY OPINION, THIS EVOLUTION HAS GONE WELL.

GAAP DOES NOT REQUIRE MARK-TO-MARKET ACCOUNTING FOR ASSETS (DOMESTIC OR FOREIGN) WHICH ARE HELD TO MATURITY IN A LOAN OR INVESTMENT PORTFOLIO. GENERALLY, ONLY ASSETS HELD IN TRADING PORTFOLIOS ARE VALUED AT MARKET.

THE VALUATION OF LOANS, EITHER BY THE ACCOUNTANTS OR THE BANKING AGENCIES, GENERALLY IS MADE THROUGH THE AUDIT OR EXAMINATION PROCESS. VALUATION IS A FUNCTION OF PERCEIVED CREDIT-WORTHINESS. GENERALLY, FOREIGN LOANS ARE EXAMINED THE SAME WAY AS DOMESTIC LOANS. IN CASES WHERE THE COLLECTIBILITY OF A LOAN APPEARS QUESTIONABLE OR LATENT RISK IN THE PORTFOLIO INCREASES, REGULATORS WILL ADVISE THE BANK TO INCREASE ITS LOAN LOSS PROVISIONS. AS WE TESTIFIED DURING 1983 BEFORE THIS COMMITTEE, UNLIKE DOMESTIC LOANS, FOREIGN LOANS CONTAIN AN ADDITIONAL FACTOR CALLED TRANSFER RISK. IT IS THE RISK THAT FOREIGN EXCHANGE MIGHT NOT BE AVAILABLE FOR ORDERLY REMITTANCE OF LOAN PAYMENTS. THE BANKING AGENCIES EXAMINE TRANSFER RISK THROUGH THEIR INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE ("ICERC"). BECAUSE THIS RISK VARIES DEPENDING ON A

COMPLEX VARIETY OF MACRO AND MICRO-ECONOMIC MATTERS, THE BANKING AGENCIES HAVE FOUND THAT THE BEST WAY TO ADDRESS IT IS BY ENCOURAGING BANKS WITH FOREIGN LOANS TO SUBSTANTIALLY IMPROVE THEIR CAPITAL AND LOAN LOSS RESERVES, AS WELL AS DISCLOSE A GREAT DEAL TO THE PUBLIC MARKETPLACE.

ON THE SUBJECT OF DISCLOSURE, I DO NOT BELIEVE ANY COMMERCIAL ACTIVITY HAS BEEN MORE PUBLICIZED OR DISCLOSED THAN HAS U.S. BANKS' NEGOTIATIONS AND HOLDINGS OF LDC LOANS. THE MARKET PLACE RECEIVES A CONSTANT FLOW OF INFORMATION ABOUT U.S. BANKS' ACTIVITIES VIS-A-VIS THEIR INTERNATIONAL LENDING, AND THE COLLECTIVE VIEW OF THAT MARKETPLACE INFLUENCES U.S. INTERNATIONAL BANKING DAILY.

NOW, I WOULD LIKE TO ANSWER YOUR SPECIFIC QUESTIONS.

1. DOES PRESENT REGULATORY OR ACCOUNTING PRACTICE REQUIRE THAT THE ASSET VALUE OF A LOAN BE WRITTEN DOWN IF THE LENDER NEGOTIATES A SIGNIFICANT REDUCTION IN THE INTEREST RATE?

NEITHER REGULATORY NOR GENERALLY ACCEPTED ACCOUNTING PRINCIPLES REQUIRE AN AUTOMATIC WRITE-DOWN OF A LOAN AS A RESULT OF A SIGNIFICANT REDUCTION IN THE LOAN'S INTEREST RATE. THIS DETERMINATION IS BASED UPON THE ACCOUNTING PRINCIPLE CONTAINED IN FINANCIAL ACCOUNTING STANDARD NO. 15, "ACCOUNTING BY DEBTORS AND CREDITORS FOR TROUBLED DEBT RESTRUCTURINGS" (FAS 15).

ALTHOUGH THIS STANDARD DOES NOT TYPICALLY REQUIRE A LOAN WRITE-DOWN, DISCLOSURE OF THE RESTRUCTURING AND ITS IMPACT ON EARNINGS IS REQUIRED. THIS DISCLOSURE INCLUDES: (1) THE AMOUNT OF THE LOAN RESTRUCTURED; (2) THE INTEREST INCOME THAT WOULD HAVE BEEN RECORDED UNDER THE ORIGINAL TERMS; (3) THE AMOUNT OF INTEREST INCOME THAT WAS INCLUDED IN NET INCOME FOR THE PERIOD; AND, (4) THE AMOUNT OF COMMITMENTS, IF ANY, TO LEND ADDITIONAL FUNDS TO THE BORROWER. (MANY MARKET PLACE ANALYSTS INCLUDE THESE RESTRUCTURED LOANS IN THE BROAD CATEGORY GENERALLY REFERRED TO AS "NON-PERFORMING LOANS").

IN APPLYING FAS 15, THREE CONSIDERATIONS SHOULD BE MENTIONED. FIRST, A LOSS ON A TROUBLE DEBT RESTRUCTURING IS NOT RECOGNIZED, PROVIDED THE EXPECTED FUTURE CASH PAYMENTS FROM THE BORROWER WILL AT LEAST EQUAL THE BOOK VALUE OF THE LOAN. SECOND, A CREDIT ANALYSIS IS REQUIRED TO ASCERTAIN WHETHER THE BORROWER CAN ACTUALLY MAKE THESE EXPECTED FUTURE PAYMENTS. IF NOT, A WRITE-DOWN OF THE LOAN OR ADDITIONAL PROVISION TO THE LOAN LOSS RESERVE MAY BE REQUIRED. FINALLY, IF THE REDUCED INTEREST RATE IS EQUAL TO OR EXCEEDS CURRENT MARKET RATES FOR SIMILAR RISK, THE RESTRUCTURING ISN'T REQUIRED TO BE REPORTED AS A TROUBLED DEBT RESTRUCTURING, AND THE DISCLOSURE REQUIREMENT MENTIONED PREVIOUSLY IS NOT NECESSARY.

2. WHAT ARE THE FACTORS USED TO DETERMINE WHETHER A LOAN IS CATEGORIZED AS "VALUE IMPAIRED" UNDER THE RULES ESTABLISHED PURSUANT TO THE INTERNATIONAL LENDING SUPERVISION ACT? WHAT FACTORS DETERMINE THE CLASSIFICATION "OTHER TRANSFER RISK"? IN THE EVENT THAT PLACEMENT IN ONE OF THESE TWO CATEGORIES IS INDICATED, ARE ALL LOANS TO A GIVEN BORROWER SO CATEGORIZED, REGARDLESS OF THE TERMS, SECURITY OR COLLATERAL OF THE LOAN? ARE NEW LOANS MADE TO SUCH COUNTRIES AUTOMATICALLY PLACED IN THE SAME CATEGORY, REGARDLESS OF TERMS, SECURITY OR COLLATERAL?

WHETHER A CATEGORIZATION OF OTHER TRANSFER RISK OR VALUE IMPAIRED IS REQUIRED FOR NEW LOANS IS DETERMINED BY THE AGENCIES ON THE BASIS OF A COUNTRY'S PERFORMANCE. IN IMPLEMENTING THE PROVISIONS OF ILSA, THE AGENCIES RECOGNIZE THE IMPORTANCE TO THE STABILITY OF BOTH THE INTERNATIONAL BANKING SYSTEM AND WORLD ECONOMY OF PROVIDING CONTINUED FUTURE INTERNATIONAL FLOWS OF BANK CREDIT.

THE FEDERAL BANKING AGENCIES, PURSUANT TO ILSA, DETERMINE INTERNATIONAL ASSETS ARE "VALUE IMPAIRED" WHEN:

- O A COUNTRY THAT HAS PROTRACTED ARREARS, AS INDICATED BY MORE THAN ONE OF THE FOLLOWING:
 - THE COUNTRY HAS NOT FULLY PAID ITS INTEREST FOR SIX MONTHS;
 - THE COUNTRY HAS NOT COMPLIED WITH IMF PROGRAMS (AND THERE IS NO IMMEDIATE PROSPECT FOR COMPLIANCE);
 - THE COUNTRY HAS NOT MET RESCHEDULING TERMS FOR OVER ONE YEAR;
- O THE COUNTRY SHOWS NO DEFINITE PROSPECTS FOR AN ORDERLY RESTORATION OF DEBT SERVICE IN THE NEAR FUTURE.

THE AGENCIES USE THE CATEGORY OTRP WHEN:

- O A COUNTRY IS NOT COMPLYING WITH ITS EXTERNAL DEBT SERVICE OBLIGATIONS, AS EVIDENCED BY ARREARS, FORCED RESTRUCTURING, OR ROLLOVERS. HOWEVER, THE COUNTRY IS TAKING POSITIVE ACTIONS TO RESTORE DEBT SERVICE THROUGH ECONOMIC ADJUSTMENT MEASURES, GENERALLY AS PART OF AN IMF PROGRAM;
- O A COUNTRY IS MEETING ITS DEBT OBLIGATIONS, BUT NON-COMPLIANCE APPEARS IMMINENT; OR,
- O A COUNTRY HAS EXPERIENCED A SEVERE DEBT SERVICE PROBLEM, AND IS NOW COMPLYING WITH THE TERMS OF IMF AND RESCHEDULING PROGRAMS. HOWEVER, SUSTAINED RESUMPTION OF ORDERLY DEBT SERVICE NEEDS TO BE DEMONSTRATED.

THE BANKING AGENCIES MAY DETERMINE THAT ONE CATEGORY, SUCH AS VALUE IMPAIRED OR OTRP, MAY APPLY TO ALL U.S. BANK LOANS IN A COUNTRY, OR THAT SEPARATE CATEGORIES APPLY, DEPENDING ON THE TYPE OR MATURITIES U.S. BANKS HAVE. FOR EXAMPLE, A COUNTRY MAY PRIORITIZE PAYING TRADE FINANCING AND INTER-BANK DEPOSITS, BUT NOT OTHER SHORT AND LONG TERM LOANS. THE PERFORMING TRADE AND BANK CREDITS, THEREFORE, WOULD BE ACCORDED A LESS SEVERE CATEGORIZATION THAN THOSE CREDITS THAT ARE NOT PERFORMING.

SIMILARLY, THE AGENCIES CONSIDER COLLATERAL FOR PARTICULAR LOANS IN A COUNTRY. CREDITS THAT ARE SECURED OR GUARANTEED BY RESIDENTS OF OTHER COUNTRIES ARE CONSIDERED THE COUNTRY RISK OF THAT OTHER COUNTRY, NOT THE RISK OF THE OBLIGOR'S COUNTRY. INSURANCE POLICIES OR GUARANTEES COVERING SPECIFIC ASSETS, AND THAT GUARANTEE PAYMENT MAY ALSO BE REALLOCATED TO THE COUNTRY OF THE INSURER. ASSETS OF A U.S. BANK'S FOREIGN OFFICE PAYABLE IN LOCAL CURRENCY FOR WHICH THE FOREIGN OFFICE HAS EQUIVALENT LOCAL CURRENT LIABILITIES ARE ALSO NOT SUBJECT TO THE VALUE IMPAIRED OR OTRP CATEGORIZATIONS.

NORMALLY, NEW LOANS ARE NOT CATEGORIZED AS VALUE IMPAIRED WHEN THE ADDITIONAL LOANS ARE MADE IN COUNTRIES IMPLEMENTING ECONOMIC ADJUSTMENT PROGRAMS. PROGRAMS APPROVED BY THE INTERNATIONAL MONETARY FUND, WHICH ARE DESIGNED TO CORRECT THE COUNTRIES' ECONOMIC DIFFICULTIES IN AN ORDERLY MANNER ARE A GOOD EXAMPLE. SUCH NEW LENDING MAY RECEIVE SPECIAL PRIORITY FOR PAYMENT, AND SO MAY STRENGTHEN THE FUNCTIONING OF THE ADJUSTMENT PROCESS, AND HELP TO IMPROVE THE QUALITY OF OUTSTANDING CREDIT, AND THUS, IT MAY BE CONSISTENT WITH THE OBJECTIVES OF IMPROVED SUPERVISION OF INTERNATIONAL LENDING.

3. HOW DO OTHER NATIONS REGULATE THE EXPOSURE OF THEIR FINANCIAL INSTITUTIONS TO HEAVILY-INDEBTED THIRD WORLD BORROWERS? WHAT IS THE BEST ESTIMATE OF THE SIZE OF THE WRITE-DOWNS OR RESERVES WHICH HAVE BEEN REQUIRED (OR TAKEN VOLUNTARILY), AGAINST DEVELOPING COUNTRY RISK BY MAJOR BANK LENDERS OVERSEAS? HOW DOES THIS COMPARE WITH THE SIZE OF WRITE-DOWNS/RESERVES TAKEN BY AMERICAN BANKS?

THE REGULATION OF THE INTERNATIONAL DEBT SITUATION BY OTHER COUNTRIES, IN PRINCIPLE, IS THE SAME AS THAT OF THE U.S. BANKING AGENCIES. HOWEVER, THE SUPERVISION VARIES IN METHODOLOGY, PRIMARILY DUE TO DIFFERENT TAX, ACCOUNTING, AND SUPERVISORY CONVENTIONS IN THOSE COUNTRIES.

AT THE POLICY LEVEL, ALL COUNTRIES DEAL WITH THE DIFFICULT PARADOX OF BALANCING MACRO AND MICRO-PRUDENTIAL REQUIREMENTS IN THE SAME WAY. FROM A MACRO-PRUDENTIAL PERSPECTIVE, SUPERVISORS SUPPORT THE COLLECTIVE ATTEMPTS TO PROMOTE CONTINUED, MODEST ADDITIONAL BANK LENDING TO LDCs. HOWEVER, THERE IS A MICRO-PRUDENTIAL REQUIREMENT THAT BANKS ALSO RECOGNIZE THE LATENT

UNCERTAINTIES INHERENT IN THE DEBT SITUATION. THE AMOUNTS OF PROTECTION TAKEN FOR EXPOSURES TO DEBTOR COUNTRIES VARIES FROM COUNTRY TO COUNTRY AND CAN BE AS MUCH A FUNCTION OF TAX OR ACCOUNTING POLICIES AS THEY ARE PRUDENTIAL REQUIREMENTS. THE AMOUNTS MAY BE MANDATED BY LAW OR REGULATION, OR THEY MAY BE STRONGLY ENCOURAGED THROUGH NEGOTIATIONS BETWEEN THE AUTHORITIES AND THE BANKS. GENERALLY, THE LIST OF COUNTRIES SUBJECT TO PROVISIONING ARE THE SAME ACROSS THE SPECTRUM OF REGULATORY SYSTEMS AND ARE THOSE COUNTRIES THAT HAVE EXPERIENCED LIQUIDITY OR DEBT SERVICE INTERRUPTIONS IN RECENT YEARS.

THE AMOUNTS OF RESERVES AND/OR WRITE-OFFS MADE BY INTERNATIONAL BANKS ALSO VARY CONSIDERABLY, DEPENDING ON WHAT IS INCLUDED IN THE SUPERVISOR'S COVERAGE OF INTERNATIONAL RISK. SOME SUPERVISORY SYSTEMS SIMPLY MAY SUBJECT ALL EXPOSURE IN A PROBLEM DEBTOR COUNTRY TO ONE, UNIFORM RESERVE REQUIREMENT. OTHER SUPERVISORS, INCLUDING THE U.S. AGENCIES, DISTINGUISH AMONG GROUPS OF PROBLEM DEBTORS AS WELL AS DIFFERENTIATE AMONG RISKS WITHIN A COUNTRY. FOR INSTANCE, THE U.S. AGENCIES PLACE 25 COUNTRIES IN OUR PROBLEM CATEGORIES. WE MANDATE SPECIFIC RESERVES OF SOME 30%-90% AGAINST SEVEN COUNTRIES. WE ENCOURAGE STEADILY INCREASING GENERAL RESERVES AND/OR CAPITAL TO REDUCE THE BANKS' OVERALL EXPOSURE AGAINST THE REST. AS MENTIONED EARLIER, THE MAJOR BANKS HAVE INCREASED CAPITAL AND RESERVES BY \$35 BILLION SINCE 1982 AND HAVE WRITTEN-OFF SOME \$6 BILLION IN INTERNATIONAL LOANS OVER THE SAME PERIOD.

BECAUSE OF THE VARIETY AND COMPLEXITY OF FOREIGN REGULATORY SYSTEMS, I AM VERY HESITANT TO ESTIMATE WHAT ACTIONS ARE BEING TAKEN IN OTHER COUNTRIES. AS A GENERAL STATEMENT, THE BANKS IN JAPAN, CANADA, U.K., AND U.S. TEND TO HAVE HIGHER EXPOSURES IN CERTAIN AREAS, SUCH AS LATIN AMERICA. THE SUPERVISORY SYSTEMS IN THESE COUNTRIES PROMOTE DEALING WITH THOSE EXPOSURES THROUGH INCREASED PUBLIC DISCLOSURE AND CAPITAL AS WELL AS AFTER-TAX PROVISIONS OF 5-10% TO GENERAL LOAN LOSS RESERVES. BANKS IN OTHER COUNTRIES MAY HAVE LESS EXPOSURES IN LATIN AMERICA AND HIGHER EXPOSURES ELSEWHERE. THEIR REGULATORY SYSTEMS PERMIT AN AVERAGE OF TAX-DEDUCTIBLE 20% PROVISIONS TO SECRET, UNDISCLOSED RESERVES. HOWEVER, THE ISSUE HERE IS NOT WHO RESERVES THE MOST, BUT WHETHER ADEQUATE PROTECTION IS BEING TAKEN. LOOKING AROUND VARIOUS BANKING SYSTEMS, I BELIEVE CORRECT POLICIES ARE IN PLACE AND ADEQUATE, DELIBERATE PROTECTION IS BEING TAKEN.

THREE VERY RECENT AND DETAILED STUDIES HAVE BEEN DONE ON THE VARIOUS SYSTEMS FOR SUPERVISING INTERNATIONAL RISKS IN DIFFERENT COUNTRIES. PEAT MARWICK, MITCHELL & CO. HAS PRODUCED A STUDY ENTITLED "ALLOWANCES FOR SOVEREIGN RISK - AN INTERNATIONAL SURVEY". EUROMONEY PUBLICATIONS HAS RECENTLY PUBLISHED "INTERNATIONAL BANK SUPERVISION" BY C. M. FRIESEN. WE HAVE PROVIDED COPIES OF THESE STUDIES FOR THE SUB-COMMITTEE'S USE.

IN ADDITION, THE ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT ("OECD") IN PARIS WILL RELEASE THIS MONTH A MONOGRAPH ENTITLED "PRUDENTIAL SUPERVISION IN BANKING" WHICH INCLUDES AN OFFICIAL DISCUSSION OF THE VARIOUS SUPERVISORY ARRANGEMENTS IN THE OECD MEMBER COUNTRIES.

4. IF A FINANCIAL INSTITUTION SELLS A PORTION OF ITS OUTSTANDING LOANS TO A GIVEN COUNTRY IN THE SECONDARY MARKET, UNDER WHAT CONDITION DOES THIS ACTION TRIGGER A WRITE-DOWN OF THE REMAINING ASSETS IN THE PORTFOLIO TO THE DISCOUNTED MARKET VALUE? IS THERE A DISTINCTION BETWEEN ASSETS HELD IN "INVESTMENT" PORTFOLIOS AND ASSETS HELD IN "TRADING" PORTFOLIOS?

WHEN A FINANCIAL INSTITUTION SELLS A PORTION OF ITS OUTSTANDING LOANS TO A GIVEN COUNTRY IN THE SECONDARY MARKET AT A LOSS, THE BASIS AND NATURE OF THE LOSS MUST BE DETERMINED BEFORE THERE IS ANY REQUIRED REVIEW OF THE REMAINING LOANS TO THAT BORROWER. IF THE LOSS IS ATTRIBUTABLE TO A MAJOR CONCERN AS TO THE COLLECTIBILITY OF LOANS FROM THAT BORROWER, ANY REMAINING LOANS TO THE BORROWER MUST BE REVIEWED FOR COLLECTIBILITY. IF THE FINANCIAL INSTITUTION CONCLUDES FROM THE REVIEW THAT ONLY PORTIONS OF THE REMAINING LOANS WILL ACTUALLY BE COLLECTED, THEN THE ESTIMATED UNCOLLECTIBLE PORTION MUST BE WRITTEN-OFF AGAINST THE LOAN LOSS RESERVE. IF, HOWEVER, THERE IS LESS CERTAINTY ABOUT ULTIMATE COLLECTION, BUT STILL SIGNIFICANT DOUBT ABOUT THE BORROWER'S ABILITY TO SERVICE THE LOAN, AN ADDITIONAL PROVISION TO THE GENERAL LOAN LOSS RESERVE MAY BE MORE APPROPRIATE.

THE METHOD USED, EITHER A DIRECT WRITE-OFF OR ADDITION TO THE LOAN LOSS RESERVE, IS JUDGMENTAL AND IS BASED UPON A COMPLETE ANALYSIS OF THE BORROWER'S CURRENT AND FUTURE REPAYMENT ABILITY. VALUES OBTAINED IN A SECONDARY MARKET MAY BE USEFUL IN THIS ANALYSIS PROVIDED THE MARKET ACTIVITY IS DEEP AND BROAD ENOUGH TO REPRESENT A RELIABLE BASIS FOR DETERMINING VALUE.

TURNING TO THE SECOND PART OF YOUR QUESTION, ASSETS HELD BY A FINANCIAL INSTITUTION ARE REFLECTED ON THEIR BOOKS AT EITHER THEIR COST TO THE INSTITUTION OR AT THE ASSET'S CURRENT MARKET VALUE. THE DECISION ON WHICH METHOD (COST OR MARKET) IS USED IS BASED UPON THE INSTITUTION'S INTENT AND ABILITY TO EITHER HOLD OR TO SELL THE ASSET. IF THE INSTITUTION BOTH INTENDS TO, AND HAS THE ABILITY TO HOLD AN ASSET UNTIL THE COST OF THE ASSET IS REALIZED IN CASH (AT MATURITY FOR LOANS), THE ASSET REMAINS ON THE INSTITUTION'S BOOKS AT THE ORIGINAL COST REGARDLESS OF CHANGES IN MARKET VALUES. "TRADING" PORTFOLIO ASSETS, ON THE OTHER HAND, ARE EXPECTED TO BE SOLD AND REALIZED THROUGH THE MARKET-PLACE, SO THE CARRYING AMOUNT ON AN INSTITUTION'S BOOKS IS BASED UPON THE CURRENT MARKET PRICE OF THE ASSET.

5. IS THE CURRENT SECONDARY MARKET AN ACCURATE INDICATION OF THE "MARKET VALUE" OF LOANS TO HEAVILY INDEBTED COUNTRIES? WOULD IT BE APPROPRIATE REGULATORY OR ACCOUNTING PRACTICE TO SEEK TO VALUE BANK ASSETS AT THE VALUES PREVAILING IN THE SECONDARY MARKET?

WE BELIEVE THAT APPLYING THE TERM "SECONDARY MARKET" TO THE CURRENT LEVEL OF TRADE IN LDC LOANS IS MISLEADING AND HAS SERVED TO CONFUSE THE ISSUES OF THE PROPER VALUATION AND ACCOUNTING TREATMENT FOR THOSE LOANS. WELL-DEVELOPED SECONDARY MARKETS HAVE DEPTH AND BREADTH, AND ARE USUALLY SUPPORTED BY PRIMARY MARKET-MAKERS. IN THE USUAL SENSE OF THE TERM, THE EXISTENCE OF A SECONDARY MARKET FOR ANY ASSET ALSO IMPLIES THAT THERE IS SOME HOMOGENEITY OF OBLIGORS, TERMS, AND LEGAL UNDERPINNINGS FOR THE INSTRUMENTS TRADED.

HOWEVER, LITTLE OF THIS INFRASTRUCTURE IS FOUND IN THE MARKET FOR LDC DEBT, AND WE BELIEVE THAT THE PRICES CURRENTLY BEING QUOTED FOR LDC DEBT REFLECT THIS. IT IS STILL A VERY THIN AND IMPERFECT MARKET. IN MY VIEW, THE CURRENT STATE OF TRADING LDC LOANS IS MORE LIKE A BAZAAR, WITH INDIVIDUAL BUYERS AND SELLERS HAGGLING OVER THE TERMS OF EACH TRANSACTION, THAN IT IS AN INSTITUTIONALIZED ARRANGEMENT WHICH SHOULD BE USED AS THE BASIS FOR VALUING THE TOTAL STOCK OF LOANS TO DEVELOPING COUNTRIES.

6. IF A LOAN WAS SOLD AT A DISCOUNT FROM FACE VALUE, AND THAT DISCOUNT WERE PASSED ALONG TO THE BORROWER IN THE FORM OF LOWER PRINCIPAL REPAYMENT OBLIGATIONS, WOULD THAT REDUCTION IN THE COUNTRY'S TOTAL DEBT BURDEN BE SEEN AS ENHANCING THE QUALITY OF THE REMAINING OUTSTANDING LOANS TO THAT COUNTRY? IF SO, WOULD PRESENT REGULATORY OR ACCOUNTING PRACTICE TREAT DISCOUNTED SALES WHICH RESULTED IN A REDUCTION OF OUTSTANDING PRINCIPAL DIFFERENTLY FROM DISCOUNTED SALES WHICH RESULTED IN NO REDUCTION OF OUTSTANDING PRINCIPAL IN TERMS OF VALUING OTHER, NON-TRADED LOANS TO THE COUNTRY IN QUESTION?

IF A DISCOUNT FROM FACE VALUE ON A LOAN WERE SOMEHOW PASSED TO A BORROWER IN TERMS OF LOWER PRINCIPAL PAYMENTS, THE RESULTING REDUCTION IN A COUNTRY'S TOTAL DEBT BURDEN WOULD ENHANCE THE QUALITY OF THE REMAINING OUTSTANDING LOANS TO THAT COUNTRY. HOWEVER, IT IS NOT CLEAR HOW REGULATORY OR ACCOUNTING PRACTICE COULD DISTINGUISH AMONG DISCOUNTED SALES IN TERMS OF THE VALUE OF THE REMAINING UNSOLD LOANS, OTHER THAN THE TREATMENT MENTIONED IN MY RESPONSE TO QUESTION 4.

7. WHAT ARE THE PRESENT ACCOUNTING STANDARDS USED TO EVALUATE THE SWAPPING OF BANK DEBT FOR OTHER ASSETS, INCLUDING EQUITY IN FIRMS IN THE BORROWING COUNTRY? DO THESE RULES MAKE IT MORE DIFFICULT OR EXPENSIVE FOR BANKS TO ENGAGE IN LOAN SWAPPING?

THE PRESENT ACCOUNTING STANDARDS FOR ASSETS RECEIVED IN SWAPPING OF BANK DEBT ARE VARIED. THE BROAD PRINCIPLE IS CONTAINED IN FAS 15 REFERRED TO EARLIER. THIS STANDARD STATES:

"THE FAIR VALUE OF THE ASSETS TRANSFERRED IS THE AMOUNT THAT THE DEBTOR COULD REASONABLY EXPECT TO RECEIVE FOR THEM IN A CURRENT SALE BETWEEN A WILLING BUYER AND A WILLING SELLER, THAT IS, OTHER THAN IN A FORCED OR LIQUIDATION SALE. FAIR VALUE OF ASSETS SHALL BE MEASURED BY THEIR MARKET VALUE IF AN ACTIVE MARKET FOR THEM EXISTS. IF NO ACTIVE MARKET EXISTS FOR THE ASSETS TRANSFERRED BUT EXISTS FOR SIMILAR ASSETS, THE SELLING PRICES IN THAT MARKET MAY BE HELPFUL IN ESTIMATING THE FAIR VALUE OF THE ASSETS TRANSFERRED. IF NO MARKET PRICE IS AVAILABLE, A FORECAST OF EXPECTED CASH FLOWS MAY AID IN ESTIMATING THE FAIR VALUE OF ASSETS TRANSFERRED, PROVIDED THE EXPECTED CASH FLOWS ARE DISCOUNTED AT A RATE COMMENSURATE WITH THE RISK INVOLVED."

APPLICATION OF THIS STANDARD TO SWAPS INVOLVING FOREIGN DEBT IS DIFFICULT. THIS IS BECAUSE THERE IS NOT A BROAD ESTABLISHED MARKET FOR THE ASSETS AND BECAUSE INDIVIDUAL COUNTRIES MAY IMPOSE SIGNIFICANT RESTRICTIONS ON THE ASSETS RECEIVED IN THE SWAP TRANSACTION. AS A RESULT OF THESE DIFFICULTIES, THE PROCESS IS HIGHLY JUDGMENTAL AND IT WOULD NOT BE UNCOMMON FOR THERE TO BE DIFFERING VALUATIONS FOR SIMILAR ASSETS. IN ORDER TO FACILITATE APPLICATION OF THIS STANDARD, BOTH THE OCC AND THE AMERICAN INSTITUTE OF CPA'S HAVE PROVIDED THE FOLLOWING ADDITIONAL FACTORS WHICH SHOULD BE CONSIDERED IN ESTABLISHING A FAIR VALUE DETERMINATION:

- O SIMILAR TRANSACTIONS FOR CASH;
- O SECONDARY MARKET VALUES, IF ANY, OF SIMILAR FINANCIAL INSTRUMENTS;
- O THE CREDIT STANDING OF THE DEBTOR AND/OR GUARANTOR (INCLUDING PROSPECTS FOR RE-ENTRY INTO THE VOLUNTARY LENDING MARKETS IN THE FORESEEABLE FUTURE);
- O PREVAILING INTEREST RATES;
- O PRICING OPTIONS AVAILABLE (E.G., PRIME-BASED VS. LIBOR-BASED LOANS); AND,
- O TAX CONSEQUENCES, INCLUDING THE EFFECT OF FOREIGN WITHHOLDING TAXES ON AFTER-TAX YIELD.

ALTHOUGH THESE FACTORS WERE ESTABLISHED FOR LOAN SWAPS, MANY ASPECTS MAY ALSO BE APPROPRIATE FOR DEBT-EQUITY SWAPS AS WELL, ALBEIT THE ACCOUNTING FRAMEWORK FOR DEBT-EQUITY SWAPS REMAINS UNCLEAR. MANY, IF NOT MOST, SWAPS DO NOT ENTAIL A NICE CLEAN

ACQUISITION OF AN EQUITY AND MANY STRINGS BIND THE LOAN SALE AND EQUITY PURCHASE. THEREFORE, THERE MAY BE NEED TO FAIR VALUE THE EQUITY RECEIVED BASED ON ALL OBJECTIVE EVIDENCE AVAILABLE.

I DO NOT VIEW THE EXISTING TREATMENT WITHIN THE ACCOUNTING PROFESSION AS AN IMPEDIMENT TO DEBT-EQUITY TRANSACTIONS AT THIS TIME, AND UNDERSTAND THE PROFESSION WILL ESTABLISH UNIFORM, PRAGMATIC GUIDANCE ON THE ACCOUNTING TREATMENT FOR DEBT-EQUITY CONVERSIONS SOON. A SIGNIFICANT CONSTRAINT ON A WIDER USE OF SWAP TRANSACTIONS AT THIS TIME SEEMS TO BE THE POLICIES IN THE DEBTOR COUNTRIES. THE COUNTRIES NEED TO PROMOTE A REASONABLE INVESTMENT AND REGULATORY CLIMATE, AS WELL AS A SUPPLY OF EQUITY OPPORTUNITIES, WHICH FIT THE RISK TOLERANCE AND BUSINESS INTERESTS OF POTENTIAL INVESTORS, INCLUDING BANKS.

THE SECOND PART OF YOUR QUESTION ASKS WHETHER THESE RULES MAKE IT MORE DIFFICULT OR EXPENSIVE FOR BANKS TO ENGAGE IN LOAN SWAPS. AS STATED PREVIOUSLY, THE PROCESS OF ASCERTAINING THE FAIR VALUE CAN BE DIFFICULT AND HIGHLY JUDGMENTAL. SIGNIFICANT COSTS, IN TERMS OF BOTH BANK PERSONNEL TIME AND OUTSIDE EXPENSES, MAY BE INVOLVED. HOWEVER, WE BELIEVE PRUDENT BANK MANAGEMENT WOULD NORMALLY PERFORM THIS TYPE OF ANALYSIS PRIOR TO DECIDING WHETHER IT IS IN THE BANK'S BEST INTEREST TO ENTER INTO THIS TYPE OF TRANSACTION. ALTHOUGH PERHAPS MORE DIFFICULT IN MANY INSTANCES, THE PROCESS IS VERY SIMILAR TO ANY INVESTMENT DECISION INVOLVING UNIQUE ASSETS. FOR EXAMPLE, NUMEROUS INSTITUTIONS ARE INVOLVED IN ACQUISITIONS OF, OR MERGERS WITH, OTHER INSTITUTIONS. FAIR VALUE DETERMINATIONS ARE REQUIRED IN MANY OF THESE TRANSACTIONS AND INVOLVE NUMEROUS AND COMPLEX VALUATIONS.

NEW DEVELOPMENTS INVOLVING U.S. BANKS AND THE DEBTOR COUNTRIES

IN MY OPINION, NO SIGNIFICANT OBSTACLES EXIST TO THE DEVELOPMENT OF MUTUALLY BENEFICIAL NEW RELATIONSHIPS BETWEEN BANKS AND THE DEBTOR COUNTRIES. HOWEVER SHOULD THEY ARISE, I AM CERTAIN THEY CAN BE OVERCOME FOR PRUDENT TRANSACTIONS. OVER THE PAST FIVE YEARS, THE ACCOUNTING PROFESSION AND BANK SUPERVISORS HAVE WORKED WELL WITHIN THE COLLECTIVE DEBT STRATEGY, WHILE AT THE SAME TIME ACHIEVING THEIR KEY OBJECTIVES OF MORE CURRENT AND MEANINGFUL PUBLIC DISCLOSURES BY THE BANKS, AS WELL AS SIGNIFICANT INCREASES IN RESERVES AND CAPITAL AT THE BANKS.

I EXPECT WE SHALL SEE SOME ENHANCEMENTS TO THE EXISTING RELATIONSHIPS BETWEEN THE BANKS AND DEBTOR COUNTRIES. THOSE RELATIONSHIPS OVER THE PAST FIVE YEARS HAVE RELIED ON A SET OF BURDEN-SHARING ARRANGEMENTS KEYED TO CONTINUAL NEGOTIATIONS OF DEBT RESCHEDULING AND NEW MONEY PACKAGES BASED ON HUNDREDS OF BANKS' EXPOSURE POSITIONS AS OF AUGUST 1982. THESE ARRANGEMENTS HAVE SERVED THE STABILITY OF THE INTERNATIONAL FINANCIAL SYSTEM VERY WELL. THEY HAVE BEEN SUCCESSFUL IN RESTORING COUNTRIES'

LIQUIDITY AND SUPPORTING ECONOMIC ADJUSTMENTS. HOWEVER, THE PROCESS CAN INVOLVE CONSIDERABLE DELAYS IN FINALIZING VITAL FINANCING AGREEMENTS. WHILE PROGRESS IS NOW BEING MADE ON A NUMBER OF RESCHEDULING AND NEW MONEY PACKAGES, GREATER FLEXIBILITY IN THE BANKS' SYNDICATION PROCESS MAY BE NEEDED TO BETTER SUIT THE NEEDS OF THE VARIOUS PARTIES.

THEREFORE, AND WITHIN THE PROGRAM FOR SUSTAINED GROWTH INITIATED BY SECRETARY BAKER, IT MAY BE TIME FOR THE COMMERCIAL BANKS TO CONSIDER A BLEND OF FINANCING ALTERNATIVES WHICH WILL MAINTAIN THE COLLECTIVE SUPPORT AND NET NEW FINANCING REQUIRED FOR LDC GROWTH, WHILE ALSO MATCHING THE STRATEGIES OF VARIOUS BANKS AND THEIR PARTICULAR NATIONAL SUPERVISORY OR ACCOUNTING SYSTEMS. SUCH OPTIONS AS REPRICING, RETIMING, OR ASSET CONVERSIONS WOULD SEEM TO BE ENTIRELY WITHIN THE EXISTING CASE-BY-CASE APPROACH AND COULD FACILITATE FUTURE RESCHEDULINGS AND NEW MONEY ARRANGEMENTS.

FINALLY, ANY DISCUSSION ABOUT POLICIES AND PRACTICES TOWARD NEW FINANCIAL RELATIONSHIPS BETWEEN DEVELOPING COUNTRIES AND THEIR BANKERS MUST CONSIDER THE POLICIES, REGULATIONS, AND PRACTICES IN THE DEVELOPING COUNTRIES. IT IS FUNDAMENTAL THAT THEY PROVIDE INCENTIVES FOR NEW FINANCIAL ARRANGEMENTS, INCLUDING MORE HOSPITABLE POLICIES FOR FOREIGN DIRECT AND EQUITY INVESTMENTS. THE DEVELOPING COUNTRIES NEED TO PROMOTE A REASONABLE ENVIRONMENT, AND THEIR OWN IDEAS FOR FINANCING OPTIONS, THAT FIT THE INTERESTS OF THEIR BANKING PARTNERS. IF THE DEBTOR COUNTRIES ESTABLISH THOSE REASONABLE POLICIES, I AM SURE MORE MUTUALLY BENEFICIAL RELATIONSHIPS WILL DEVELOP.

Senator SARBANES. Well, thank you very much. We will hear now from Mr. Keaveney.

STATEMENT OF THOMAS F. KEAVENEY, PARTNER AND NATIONAL DIRECTOR—BANKING, PEAT MARWICK MAIN & CO.

Mr. KEAVENEY. Thank you, Mr. Chairman. It's my pleasure to be here with you today and to provide you, as requested, with information regarding accounting and tax matters relevant to bank lending to heavily indebted, less developed countries. My written testimony in this regard was previously provided to the committee and, as requested in the interest of time and in light of the comments made by other members of this panel, I will confine myself to summary comments plus focus on one or two specific matters.

In my opinion, the framework of generally accepted accounting principles as applied to LDC debt has not detracted from the orderly and disciplined process of restructuring and expanding LDC and banker relationships.

In fact, the financial reporting and disclosure by banks of their LDC lending has been substantial and has, I believe, allowed our capital markets to fully evaluate them in the context of bank performance as a whole, while at the same time putting the banks in the position where they can work with each LDC in a free market environment to produce over time appropriate solutions to meet the needs of both debtors and creditors.

One aspect of the accounting framework that I would like to comment on is contained on page 3 of my written testimony in the second full paragraph.

CREDIBLE ACCOUNTING IN FINANCIAL STATEMENTS

Deferral of loans losses for LDC loans and accounting procedures suggested by some would not be in accordance with generally accepted accounting principles and, in my opinion, would jeopardize the credibility of bank financial statements.

The need for credible accounting in financial statements is essential. The success of the U.S. financial markets is largely based on having credible financial information. Any proposal by this subcommittee I believe should support, not subvert, credibility of those financial statements.

I would now like to turn my attention to the aspects of the Tax Reform Act of 1986, which I believe is relevant to the LDC-banker relationship.

TAX REFORM ACT OF 1986

The tax aspects may in fact be the detriment to the U.S. banks in developing these relationships—two aspects.

First, the elimination of the bad debt reserves in the Tax Reform Act of 1986. In sum, because of the elimination of these reserves, larger banks which are the major LDC lenders are confronted with an additional cash flow burden and placed at a competitive disadvantage with many foreign banks where tax laws allow for some form of current tax relief on bad debts and could in the future be faced with requirements to write off deferred tax assets if new ac-

counting requirements are adopted by the Financial Accounting Standards Board on income tax.

For further information in this area I have made available to the staff and the subcommittee copies of two reports previously prepared by our firm. The first deals specifically with the question of whether the bad debt reserves should be preserved in tax law, and the second is the international comparison of bad debt provisions for tax purposes I referred to previously.

The second tax issue worthy of your consideration is the foreign tax credit limitation recently enacted in the Tax Reform Act of 1986. Essentially, to the degree that a bank cannot credit its withholding taxes, its economic burden of taxation may exceed the highest U.S. marginal rate of taxes. Consequently, when the withholding tax is paid to foreign governments, usually in the case of LDC's where those taxes are at the high end, are added to the U.S. taxes paid on its income, banks with excess tax credits will pay substantially more tax in total than competitor institutions not having cross-border loans.

This is a real burden to banks, particularly as much as cross-border lending is LDC related, and obviously this will then become over time as these new tax rules trigger in 3 years hence a significant disincentive for such banks to extend new LDC loans where they will not be able to avail themselves fully of the foreign tax credits.

In summary, I believe that reinstatement in the tax code of the reserve method for loan losses and relief with respect to the foreign tax credit limitation, at least as it applies to LDC loans, would remove an obstacle to American banks to continue to work in the free market framework with LDC borrowers in restructuring and expanding lender-borrower relationships.

Thank you, Mr. Chairman, for your attention. I will be pleased to answer any questions you may have.

[The complete prepared statement of Thomas J. Keaveney follows:]

STATEMENT OF THE
FINANCIAL ACCOUNTING STANDARDS BOARD
TO THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

APRIL 2, 1987

The Financial Accounting Standards Board (FASB) appreciates the opportunity to submit this statement to the Subcommittee. In accordance with the Subcommittee's request, this submission addresses certain aspects of accounting standards affecting Third World debt. The FASB has not addressed the accounting for Third World debt specifically but rather the broader issue of accounting for debt regardless of the identities of the lender and borrower. This submission specifically describes the requirements and interrelationship of two pronouncements of the FASB. FASB Statement No. 5, Accounting for Contingencies, applies to the accounting for all debt, and FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, applies to the accounting for certain debt.

The pronouncements of the FASB apply broadly to all business enterprises, including financial institutions, that prepare financial statements in accordance with generally accepted accounting principles. Additional, industry specific, guidance is found in the American Institute of Certified Public Accountants Industry Audit Guide, Audits of Banks. The term "generally accepted accounting principles" describes a body of literature and accepted practice that is designed to provide relevant, reliable, and useful information to investors, creditors, and other users of general purpose financial statements.

Collectibility of Loans

A lender advances cash with the expectation that the future cash receipts specified by the terms of the agreement will provide a return of the amount loaned as well as a return or yield on the loan. The conditions under which loans exist frequently involve some degree of uncertainty about their collectibility. Statement 5 provides guidance on the accounting for contingencies, including collectibility of receivables. Statement 5 was issued in March 1975, but with respect to collectibility of receivables, it merely codified a longstanding practice.

Statement 5 requires loss recognition when it is probable that an asset has been impaired and that impairment can be reasonably estimated. That assessment may be considered in relation to individual loans or in relation to groups of similar types of loans. If the conditions of Statement 5 are met, loss recognition is required even though the particular loans that are uncollectible may not be identifiable. If the reasonable estimate of the loss is a range, the lender must recognize a loss at least equal to the minimum amount in the range.

The assessment of the collectibility of loans involves numerous factors, including the experience of the lender, information about the ability of

debtors or guarantors to pay, the current economic environment, and the value and accessibility of specific collateral or other assets of the borrower or of guarantors. If such assessment of a loan receivable shows that all or a portion of a loan or group of loans is uncollectible, Statement 5 requires recognition of the uncollectible portion as a loss.

The FASB recognizes that the determination that all or a portion of a loan is uncollectible is not a clear-cut, objective decision, but rather is subjective and involves careful judgment. Different individuals, financial institutions, or other enterprises may evaluate similar facts and come to different conclusions regarding the extent to which an asset has been impaired. That is no different from similar evaluations in other fields, such as medicine or law, for which the outcome of an assessment cannot be known until the matter is finally resolved.

Accounting for Troubled Debt Restructurings

Recent testimony before committees of this Congress and the 99th Congress has focused particular attention on Statement 15 as the appropriate authoritative pronouncement to be used by banks with loan concentrations in certain troubled sectors in accounting for the restructuring of those loans. That attention has seemingly ignored the fact that Statement 15 is required to be followed by all debtors and creditors in the preparation of financial statements in accordance with generally accepted accounting principles. The accounting has been characterized incorrectly by some as a means for banks to avoid recognizing losses on those loans.

The FASB issued Statement 15 in June 1977 to establish standards of financial accounting and reporting by the borrower and lender for a troubled debt restructuring. The complete conclusions and rationale are included in Statement 15. Statement 15 does not address accounting for allowances for estimated uncollectible amounts. As discussed above, the Board had previously addressed the accounting and disclosure for estimated losses on receivables in Statement 5 and the principle that a loss is recognized when full collection becomes unlikely existed long before that. The summary which follows is a general description of the issues and the conclusions of Statement 15.

Statement 15 defines a troubled debt restructuring as follows:

A restructuring of a debt constitutes a troubled debt restructuring . . . if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity

interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment. [Footnote reference omitted.]

A troubled debt restructuring can involve (a) a transfer from the borrower to the lender of receivables from third parties, real estate, or other assets in full or partial satisfaction of the debt; (b) issuance or other granting of an equity interest to the lender by the borrower in full or partial satisfaction of the debt; (c) a modification of the terms of the debt; or (d) some combination of the above. The modifications of the terms of a debt referred to in (c) above include (i) a reduction of the stated interest rate, (ii) extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk, (iii) reduction of the face amount of the debt, (iv) reduction of previously accrued interest, or (v) some combination of (i)-(iv) above.

Statement 15 distinguishes troubled debt restructurings based on their substance. The Board concluded that troubled debt restructurings could be considered as two types: (a) those that involve transfers of resources by the borrower to the lender in full settlement of the borrower's obligation and (b) those that involve a modification of terms whether or not the modification involves the transfer of resources by the borrower to the lender. In Statement 15, the Board concluded that a troubled debt restructuring that involves the transfer of receivables from third parties, real estate, or other assets or the issuance or other granting of equity interests to settle a loan requires accounting for the resources transferred at fair value and recognition of gain or loss. In contrast, if a troubled debt restructuring involves a modification of terms without full settlement through a transfer of resources, the restructured debt is considered a continuation of the existing debt with modified terms.

Most of the recent attention to Statement 15 has focused on the standards related to the lender's accounting for a troubled debt restructuring that involves a modification of terms. Accordingly, this submission concentrates on accounting by the lender that is set forth in Statement 15 for this type of restructuring.

Modification of Terms of a Loan

Modification of terms of debt is not unusual for financial institutions. Restructurings, whether considered troubled or not, affect the contractual cash flows between the borrower and the lender but may not require accounting recognition until other events occur. In a troubled debt situation, the borrower is unable to perform under the terms of the existing loan agreement. In these circumstances, the lender evaluates the alternatives available to maximize its cash flows from the loan. In assessing its cash flow prospects, a lender may look either to collections from the borrower--the likely future

cash receipts of interest and face amount--or to amounts recoverable from potential pursuit of specific collateral or other assets of the borrower or guarantors.

In order to maximize realization of future cash flows, the lender may grant a concession to the borrower, a concession not contemplated when the loan was made and one that would not otherwise be granted absent the borrower's financial difficulties. In granting the concession, the lender unilaterally may forfeit its right to some contractual cash flows. Whether granting the concession provides the basis for recognition of a loss requires analysis of the terms of the concession; a loss is not recognized merely because the borrower has not complied with the original requirements of the loan and the original loan terms have been modified.

Whatever the form of the concession granted to the borrower, the lender's objective is to make the best of a difficult situation because the borrower has financial difficulties. The lender grants concessions to improve the prospects of collectibility or enhance the value of the loan. Depending on the type of concession granted and whether that concession is granted in partial or full settlement of the borrower's obligation, different accounting issues arise.

Two major issues arise in accounting by a lender for a troubled debt restructuring that involves a modification of terms. If the modified terms provide for the borrower to repay in total at least the remaining unpaid principal of the loan, the first issue involves whether to:

- a. make no change in the recorded investment for the receivable and recognize the effects of the modification in the future as reduced interest income over the term of the restructured debt, or
- b. recognize a loss by reducing the recorded investment and thereafter recognize higher interest income based on the market rate of interest for such a loan at the time of the restructuring.

The second issue involves two related questions. The first question is whether the accounting procedure selected above should apply both to modifications in the timing of payments and to modifications in the amounts to be paid. The second question is whether the same accounting should apply both to modifications of amounts designated as interest and to modifications of amounts designated as face amount.

Statement 15 concluded that if a restructuring involves a modification of terms, the restructured loan continues an existing loan with changed terms. The effect on total cash flows is the issue, not whether the modifications apply to the cash flows designated as face amount or those designated as interest. The lender's primary objective is to enhance the prospects for recovery of its investment by reducing the effective interest rate for recovery of the restructuring to maturity. A lender would generally prefer to alleviate the borrower's cash difficulties by deferring payment of

the amount designated as face amount rather than by reducing it because deferring payment may better preserve a lender's maximum claim in the event of the borrower's bankruptcy. Statement 15 requires that the accounting for that kind of modification be consistent with the accounting for other modifications of terms affecting future cash flows.

Statement 15 provides that accounting for the restructured debt should be based on the effect on cash flows—not on the labels of face amount and interest used to designate those amounts. Statement 15 views the lender-borrower relationship as encompassing all required cash flows under the agreement, not merely the cash flows designated as repayment of the face amount. When a loan is made, the recorded investment in a loan represents the present value of all future cash receipts specified by the terms of the debt discounted at an effective interest rate. Whether an amount due at a particular time is described as face amount or interest does not affect either the present value of the receivable or its effective interest rate.

Statement 15 requires loss recognition to the extent that the restructured aggregate cash flows are less than the recorded investment of the receivable, concluding that a troubled debt restructuring involving a modification of terms affects primarily the future effective interest rate. Accordingly, the effective interest rate implicit in the restructured loan and the aggregate cash flows specified by the modified terms are used by the lender to recognize interest income between the date of restructuring and the maturity date.

When a lender has concluded that the renegotiation of loan terms meets the Statement 15 definition of a troubled debt restructuring, Statement 15 requires disclosures by the lender of the effects of the restructuring. A lender must disclose the aggregate recorded investment, the gross interest income that would have been recorded in the period on those loans without the restructuring, and the amount of interest income that was included in net income for the period. Those required disclosures serve to inform users of the lender's financial statements about the effects of concessions granted to the borrower.

The accounting set forth in Statement 15 is generally symmetrical for the lender and the borrower. Thus, in restructurings that involve a modification of terms, the borrower recognizes no gain unless the carrying amount of the debt exceeds the total future cash payments specified by the new terms. The effects of the restructuring are reflected in future periods by the borrower as less interest expense.

When the FASB solicited public comment on the accounting that is now set forth in Statement 15, some respondents argued that the lender should adjust the restructured loan to its fair value by discounting the modified cash flows at a current market rate or, alternatively, subject the modified terms to a present value calculation with the cash flows discounted at the pre-restructuring rate. Other respondents advocated loss recognition only by the lender in restructurings that involved a reduction of the amount designated as

face amount. If either of those approaches had been adopted in Statement 15, lenders would generally recognize a loss at the date of restructuring followed by recognition of higher interest income on the modified loan. The Board rejected both of those approaches for debt restructurings involving a modification of terms.

In issuing Statement 15, the FASB knew its provisions would be controversial. The standard resulted from the Board's normal procedures which involve extensive due process prior to the issuance of a final standard. In reaching the conclusions set forth in the standard, the Board considered and ultimately rejected a number of other accounting approaches. The reasons for the Board's acceptance or rejection of various views are summarized in the Basis for Conclusions portion of the Statement.

Evaluation of Collectibility of a Troubled Debt

Accounting for restructured debt in accordance with Statement 15 does not relieve a financial institution of its obligation under Statement 5 to evaluate the collectibility of the amounts due under the newly restructured terms. The fact that the loan arrangement needs to be restructured is evidence that ultimate collectibility is not assured. FASB Technical Bulletin No. 79-6, Valuation Allowances Following Debt Restructuring, and footnotes 18 and 34 of Statement 15 provide that an assessment of the collectibility of a loan with modified terms is necessary following a troubled debt restructuring. As noted earlier in the submission, if assessment of a loan receivable shows that all or a portion of a loan is uncollectible, Statement 5 requires recognition of the loss.

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The Financial Accounting Standards Board appreciates this opportunity to provide the Subcommittee with background information about certain significant accounting issues relevant to Third World debt.

STATEMENT OF THOMAS F. KEAVENEY
PARTNER AND NATIONAL DIRECTOR - BANKING
FEAT MARWICK MAIN & CO.

BEFORE THE
INTERNATIONAL FINANCE & MONETARY POLICY SUBCOMMITTEE

OF THE
COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
UNITED STATES SENATE

APRIL 2, 1987

Chairman Sarbanes and Members of the Subcommittee, my name is Thomas F. Keaveney. I am a certified public accountant, a partner and national director of banking with the independent accounting firm of Feat Marwick Main & Co. I have over 25 years experience as an independent accountant and auditor, including 18 years as a Feat Marwick partner responsible for auditing multinational banks and the U. S. operations of foreign banks. I was a member of the Banking Committee of the American Institute of Certified Public Accountants and past Chairman of its Subcommittee on foreign loans.

As requested in your letter of March 23, 1987, I am here today to comment on relevant accounting and recent tax code issues affecting U. S. commercial banks with loan exposures to heavily indebted less developed countries (LDC's). Specifically, I will discuss:

- a. accounting for loan losses
- b. Financial Accounting Standard Board Opinion 19, "Accounting for Debtors and Creditors for Troubled Debt Restructuring"

a. accounting for loan losses - that includes the exchange of debt obligations for equity instruments and subsequent transfer to off-balance sheet

b. accounting for off-balance sheet loans - that includes the notes received in foreign bank on interest payments on restructured Philippine debt

c. repeal of the tax deduction for loan loss reserve additions for larger banks only

d. foreign tax credit limitations included in the Tax Reform Act of 1986

Accounting for loan losses

The authoritative accounting guidance regarding the accounting for loan losses is contained primarily in Statement of Financial Accounting Standards No. 1, "Accounting for Overhead Costs," and the APB's Industry Audit Guide, "Audit of Banks."

This guidance requires that a provision for loan losses be charged to income if it is probable that a loss of loan principal has occurred and the amount of the loss can be reasonably estimated. An allowance for loan losses should be established if these conditions can be satisfied for a loan. Overall, the allowance for loan losses must be adequate to cover all losses inherent in a bank's loan portfolio, regardless of the type or nature of the loans.

considerable progress in other aspects of restructuring the rules of the Allowance for Troubled Debt. Some of the long-standing issues, however, current accounting rules do not allow for the recognition of such provisions into the income of a business enterprise.

Deferral of loan losses for the issuer, as accounting principles suggest by some, would not be in consonance with generally accepted accounting principles and, in my opinion, would jeopardize the credibility of loan financial statements. The need for credible accounting and financial statements is essential. The success of the United States financial markets is largely based on getting credible financial information, and proposed to this Subcommittee should support, not weaken, the credibility of loan financial statements.

PAGE 15 - Troubled Debt Restructuring

Financial Accounting Standard Board Opinion No. 31, "Accounting for Troubled Debt Creditors for Troubled Debt Restructurings" was adopted by the Board to provide guidance to lenders in accounting for restructuring of loans to borrowers experiencing financial difficulty and unable to make payments on the loans.

As an integral part of the process of issuing judgments, loan loss provisions should be established in accordance with the provisions of the Act that are significant in relation to troubled debt. A postponement of the financial impact of the loss is inconsistent with the intent of the Act.

Consistent with the Board's view, if generally accepted accounting principles previously described, as well as accounting treatment for forgiveness of principal will require the lender to record an immediate loan loss. Other restructuring, including reduction of interest or reduction of both principal and interest, would result in an immediate loan loss provided the future payments of interest and principal, when combined, equal or exceed the original amount of the loan. Such restructuring or, however, result in economic losses to the lender, in accordance with generally accepted accounting principles. As a result of these actions, in the form of reduced interest earned, the lender's economic losses will mean that a bank will have less assets available to pay off loans. The depositors and stockholders do not understand.

Proposals have been made to the Bank, including restructuring of loans in a form that would qualify for debt restructuring provisions. It should be understood

Senator SARBANES. Thank you. Could you take just a moment to talk about the Philippine investment notes that's involved in the new arrangement?

PHILIPPINES INVESTMENT NOTES

Mr. KEAVENEY. Sure. I'll be glad to. The Philippine investment notes, as I indicated in my prepared testimony, there is considerable uncertainty as to all the details pending receipt of the documentation, but as we understood it at the time that was written, the banks would have a choice of cash or PIN's, and as we understood it at the time, the cash would essentially provide interest at a slightly lower rate than was inherent in the PIN's and our conclusion was that as long as they had a choice and these PIN's were ultimately marketable and valuable that they could potentially recognize income on these PIN's currently based on the current cash value of those PIN's when they acquire them.

Senator SARBANES. Let me put this question to anyone on the panel who wishes to respond. What are the problems you foresee if we start trying to treat LDC debt differently in terms of how we handle it for accounting and financial purposes?

I mean, some of the proposals talk about handling it in a different way. Is that a reasonable thing to examine doing or do you see that leading into other problems and to sound a caution about taking that approach?

Mr. LEISENRING. I would be happy to respond from the accounting standards standpoint, Mr. Chairman. I recall a remark that Senator Gramm said early this morning when he indicated that we enjoyed in this country the world's greatest market system, and I would agree with that observation. One major reason for the presence of that market in this country is both the availability but more importantly I think the credibility of the information of which financial information is a very significant part.

A good many of the things that I have seen proposed would, in my opinion, dramatically undermine the credibility of that very cornerstone of our sophisticated market system. It would add significant credibility concerns about financial reporting of those engaged in LDC debt. It would cause uncertainties as to what the consequences of peculiar accounting might be and, as some people have testified earlier this morning, many people at least believe the banks with significant LDC exposure are already penalized in the capital market. I can't understand how adding another accounting uncertainty or an accounting gimmick into their financial reporting is going to do anything but exacerbate the problems.

Senator SARBANES. What gimmicks are you thinking of?

Mr. LEISENRING. The gimmicks that would be high on my list—there are several of them but certainly one of them is deferral of loan loss provisions. If you decided something is probable that it's not going to be collected, then there is very little economic benefit left to continue to be recognized as an asset. If you've reached that conclusion, the proper time to recognize the loss is when that conclusion is reached, not over some period of time so that you can creep up on the problem. That's by far the most significant gimmick and the one that people have suggested in this Congress for

treatment of the thrift and other problems other than LDC debt. Deferral of losses seems to be a common solution.

The FASB has taken the position consistently that if the Congress or regulators want to change the regulatory requirements the more appropriate way to do that is to in fact change the capital requirements, but do not change the way that capital is measured. It doesn't seem productive to do that.

We think that many people are overlooking the sophistication of the marketplace to see through those kinds of accounting gimmicks and to in fact perhaps penalize the very institutions you're trying to help much more significantly than just accounting under generally accepted accounting principles would do.

Senator SARBANES. How strong is your concern that a gimmick used in the LDC arena tomorrow would be sought to be used in some domestic arena? In other words, that it really gets you on a slippery slope?

CONCERN THAT GIMMICK WILL BE USED IN LDC ARENA

Mr. LEISENRING. Well, slopes involving gimmicks are always slippery, and I don't think that's my principal concern. I just don't like what I would call fiddling around with the accounting rules to accomplish some other objective and I don't like it for LDC loans any more than I do for other types of loans. I've already indicated certainly it's been proposed for the agricultural banks and it's been proposed for the so-called oil patch banks or institutions. I think the world is best served by comparable financial information. These proposals would essentially involve legislating noncomparability.

A loss seems to me to be a loss irrespective of how it came about. Whether it came about from lending to an oil company in Mexico or lending to an oil company in Texas doesn't seem to me to be relevant to the accounting.

Senator SARBANES. Does anyone else want to comment?

Mr. KEAVENEY. Mr. Chairman, just one additional thought. I suppose as a practicing accountant we have often seen where let's say a less than best rule of accounting gets into the marketplace in one area it does tend to spread to other areas, so I think the very practical concerns you inquired about do in fact exist and I think we should all be concerned. If you start down the road in one area with less than the best accounting, how quickly is it going to spread everywhere else?

Senator SARBANES. Mr. Bench, do you have any information on what's holding up closing the Mexican loan?

Mr. BENCH. The only information I have, Mr. Chairman, is what has been published in the press and that is that there is a disagreement or ongoing discussion, if you will, involving one national group of banks that feels that the U.S. group of banks have failed to put up its commitment of 90 percent of its requirement. As I understand it, the U.S. banks basically have pledged 83.5 percent of its requirements toward the burden-sharing arrangement and the British banks feel that that number should be larger.

Senator SARBANES. What is the problem amongst the U.S. banks in putting up a higher percentage? Do you know?

Mr. BENCH. Throughout the whole Mexican refinancing there have been a number of complaints from a number of banks about the nature of the financing. Some banks complain that there's no on-lending facilities in the arrangement for them. Other banks complain that while they are being asked to put up 12 percent more of what they had in August 1982 they no longer have any of those loans so they shouldn't have to put up 12 percent on nothing.

A major problem is that all of these financings are still based on outstandings that the banks had in August 1982. Since 1982, a number of banks have sold off their loans or reduced their exposure and do not feel that they should have to put up money based on 1982; they should put up money based on what their exposure is today. I think that is probably the major holdup.

Senator SARBANES. Is there any holdup that is flowing from the regulators who are looking askance at any of the American banks participating in this Mexican loan?

Mr. BENCH. Not that I am aware of. The position of the U.S. bank regulators on the Mexican financing is that we endorse the financing overall as a support to Mexico, but we have left the individual decisions to participate in that financing entirely up to the banks.

Senator SARBANES. And of the banks that are being called upon to participate, none of them would be impeded in doing so by the regulators' evaluation of that particular bank's situation with respect to the Mexican loan, is that correct?

Mr. BENCH. That is correct. To date throughout the debt strategy, those evaluations have not been an impediment to any bank's individual decision. We have a number of banks, as you know, Mr. Chairman, that may be under some set of arrangements with us overall as to the condition of the bank or in terms of their overall classified assets. But we have not intervened in their particular lending decision or participation in the Mexican financing. We are leaving that essentially up to the board of directors of the bank.

Senator SARBANES. All right. I want to make sure I understand this. If a regulatory agency had concern about a bank's safety and soundness, it regards the Mexican loan with sufficient approbation that it would not have difficulty with a bank participating in that loan; is that correct?

Mr. BENCH. That is correct.

Senator SARBANES. Well, gentlemen, we could go for quite a while. Unfortunately, the bell has rung and I'm going to have to go and vote and I think the best thing to do, because you've been very accommodating to the committee this morning, is to let this panel go with thanks for some very carefully worked out statements, but with the hope and expectation that we can get back to some or all of you to discuss in some greater detail some of the points you've made. In fact, I think we're going to need some time to digest it and seek to integrate it into what the committee may do.

I do want to say this has been a very helpful panel and the written work you've done obviously reflects a great deal of effort. We are most appreciative of that and we will be back with you because there are some of these things we need to explore very carefully. Particularly if there's an inclination to take some kind of legislative action we want to be certain exactly what's involved.

We thank you very much for your contribution.

The committee will have to stand in recess for about 10 minutes and then I will return and we'll take the final panel which has held on for quite a while. Thank you all very much.

[Recess.]

Senator SARBANES. Gentlemen, I know it's been a long morning for you, but it's not a matter that was under our control. We would be quite happy to hear from you now. Have you worked out an order between you or why don't we just do it alphabetically?

Mr. Fox, why don't you lead off and then we'll take Mr. Schecter.

STATEMENT OF LAWRENCE FOX, VICE PRESIDENT OF INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Fox. Thank you very much, Mr. Chairman. I will summarize my remarks and I appreciate your making the full testimony part of the record.

EXCHANGE RATE DEVELOPMENTS

Our purpose this morning is to comment on the exchange rate developments and to do so in some relationship to the omnibus trade bill which may have a section dealing with the exchange rate.

The point of view that we express concerns the relationship between the dollar exchange rate and the ability of the United States to turn the trade deficit around.

As you know, the expectation that the downward movement of the exchange rate of the dollar would bring about an improvement in our trade account has so far not materialized. Most of us had anticipated that it might take 1½ or 2 years to show any benefits in the trade account, and that the improvement from that point on might be more consistent and more marked. So far, there is no improvement in the trade balance.

The deficit last year was \$170 billion. It's of great concern, of course, to the manufacturing sector of the American economy. \$145 billion of that \$170 billion is in manufactured goods, or approximately 85 percent of the total deficit is in manufacturing.

This compares with the situation in 1981 when there was actually a \$5 billion trade surplus in manufacturing. So most of the impact of the trade deficit has been on the manufacturing sector and the employees of manufacturing companies.

With respect to the exchange rate specifically, we want to comment on the importance of the Paris meeting of the group of six or group of seven, depending on how you count, and indeed what that means in relation to the future development in the exchange rate field and the impact on trade.

First, we believe that the trade deficit, although it will improve somewhat this year perhaps \$15 or \$20 billion, it will not improve rapidly enough to indicate the kind of progress that's needed either to see a positive trend of getting the trade deficit moving downward sufficiently or to meet U.S. domestic needs.

As you know, most of the economic projections this year which call for a degree of improvement in the domestic economy—virtual-

that such a course of action will require current and future losses to be recognized by the banks.

Once following this course of action, it may be unlikely that banks could make further loans to LDCs as it would not be viewed as being in the best interest of their stockholders to offer further subsidies to such countries.

Debt/Equity Swaps

Debt/equity swaps, in the LDC context, occurs where a bank is holding public or private sector LDC debt and exchanges that debt for an equity interest in a business, in that same country, for its own account. Government sponsored debt/equity swap programs are in place in several countries, including Brazil and Chile.

Typically, these programs provide that banks swap their U. S. dollar denominated LDC debt for local currency, at an official exchange rate, approximately equal to the U. S. dollar debt, after a transaction fee usually ranging from 3 to 7%. The local currency obtained by the U. S. banks must be used for an approved equity investment. It is not available for any other purpose. Dividends can generally be paid, although there may be exchange restrictions in the withdrawal of the investment. Capital usually cannot be repatriated for several years, in some cases up to twelve years.

In my view, these debt/equity swaps are exchange transactions which, under generally accepted accounting principles, should be recorded at fair value determined at the date of exchange. Normally, a loss would be recorded for the difference between the amount at which the LDC debt is carried on the books of the bank and the fair value of the swap. As there usually will not be a readily determinable market value for either of the assets exchanged in a swap, both the fair value of the consideration given as well as the fair value of the assets received must be considered in determining the fair value of the swap.

Recording a debt/equity swap transaction based solely on the valuation of the LDC debt given up, using only the so called secondary market price for LDC debt, would normally be inappropriate. Observers of this so called market that I have consulted with characterize it as very thin, volatile and not indicative of basic values. Accordingly, it will usually be necessary to look also at the fair value of the equity interest received in the swap.

An independent appraisal of the equity investment should be obtained and that appraisal should assess not only fair value of the equity in local currency but also in U. S. dollars. The appraisal of the equity interest received should also consider any restrictions on dividends and the

marketability of the investment. Considering both the appraised value of the equity interest received and the so called secondary market price for the LDC debt given up should provide sufficient information to determine the fair value of the swap and the amount of the loan to be recorded.

I believe that this approach will usually provide a more rational accounting answer than valuing the equity investment at either the face value of the LDC debt or its current trading value in the thin secondary market.

I understand that the Banking Committee of the AICPA is drafting a Practice Bulletin on this subject consistent with the views I have expressed today. The Committee presently expects approval and issuance of the Bulletin in the near future.

Philippines Investment Notes (PINIS)

Recently, it was announced that the Philippines and its creditor banks have reached an agreement to restructure the Philippines debt whereby interest thereon will be paid, at the lender's election, either in cash or PINIS. Reportedly, cash payments will be at a lower rate over libor than the implicit interest rate on the PINIS. With respect to PINIS, acquired by the banks, they will be converted to cash at a later date, either through sale in the open market, sale to investors or the peso equivalent or payment at maturity.

While this interest payment structure is complex and not all details are known at this time, this approach is generally viewed as a creative free market solution that gives appropriate weight to the best interests of both the borrower and the lenders. Similarly, creative solutions to LDC debt restructurings are expected for other countries in the future, presumably tailored to the individual circumstances in each country.

Concern has been expressed by some observers that banks may not be permitted under generally accepted accounting principles to recognize any current interest income arising from the receipt of PINIS. While it should be recognized that the agreements require detail analysis, based on what I know today, it appears that lenders who elect to receive PINIS in lieu of cash would be entitled to record the cash equivalent they could have received as current income today. Any additional income or loss which may arise from the decision to acquire PINIS would be recorded in future periods on an accrual or realization basis, as considered appropriate in such future periods.

In summary, the accounting for PINIS under generally accepted accounting principles, in my opinion, should not adversely impact current bank earnings in any significant manner.

Elimination of Bad Debt Reserves

The purported rationale for the elimination of the bad debt reserve for banks with assets in excess of \$500,000,000 as part of the Tax Reform Act of 1986 was that "the reserve method allows deductions prior to the time that the losses actually occur." H. R. Rep. No. 426, 99th Cong., 1st Sess. at 577 (1985). From an economist's point of view, the loss on a loan does not occur at any one specific point in time. Rather, a loan declines in value as the credit worthiness of the borrower deteriorates. Thus, I believe that the use of the reserve method would more fairly represent a bank's income than the disallowance of any deduction until the point in time when a loan is actually written-off. Accordingly, the elimination for larger banks of the bad debt reserve for tax purposes imposes a cash flow burden on such banks. This burden, obviously, exacerbates their problems in dealing with their LDC debt.

The elimination of the bad debt reserve for larger banks in the recent U.S. tax law is at odds with the treatment accorded bad debt reserves by most other countries. In a study conducted by our Firm in 1983, we found that 24 out of the 26 countries examined (apart from the U. S.) allowed for some form of bad debt reserve in determining taxable income. Thus, U. S. banks are at a competitive disadvantage with foreign banks holding LDC debt because of this difference between the U. S. and foreign tax laws.

The elimination of the bad debt reserve establishes a fundamental difference between the tax accounting for loan losses and that required by generally accepted accounting principles as discussed in previous sections. This difference may result in a deferred tax asset. If the proposed new set of rules for accounting for income taxes as presently being considered by FASB is adopted, a number of banks may be required to write-off this asset in future years when they cannot establish that the asset will result in a tax benefit based on the loss carryback provisions in the tax law. Such a write-off, if required, would, of course, reduce the capital of the affected banks.

With the elimination of the bad debt reserve, larger banks will be entitled to a bad debt deduction only for loans that are specifically charged-off. As a result, they will be entitled to no tax relief on any LDC debt until the debt in question is actually written-off. Moreover, there is considerable confusion regarding the new tax law as to when banks may stop accruing interest on loans even though the debtor is failing to make current interest payments (as currently may be case with Brazil).

In sum, because of the elimination of the bad debt reserve and, to a lesser extent, the confusion surrounding the accrual of interest on non-performing loans, larger banks are confronted with a cash flow burden, placed at a competitive disadvantage to many foreign banks as their

tax law allows for some form of current tax relief on bad debts and could be faced with the requirement to write-off deferred tax assets if new accounting requirements are adopted by the FASB. These issues arise in dealing with LDC debt and other loans made by larger banks as well.

For your further information in this area, I am making available to the staff of the Subcommittee copies of two reports previously prepared by Peat Marwick. The first deals specifically with the question of whether the bad debt reserve should be preserved in the tax law and the second is the international comparison of bad debt provisions I referred to previously.

Foreign Tax Credit Limitation

U. S. taxpayers, including banks, pay taxes on their worldwide income, but in doing so, are permitted to credit any foreign income taxes they have paid against U. S. income taxes imposed on the same income. To confine the use of foreign tax credits to the foreign source income giving rise to them, the tax law imposes a foreign tax credit limitation. Under the old law, this limitation was calculated essentially by applying a taxpayer's effective U. S. tax rate against its total net foreign source taxable income.

A number of complicated rules were written into the new tax law. Reduced to essentials, these new rules will permit most banks to credit foreign withholding taxes on existing loans under the old law for the next three years. Thereafter, new more restrictive rules will, as applied to banks, begin to take hold that have the practical impact of reducing foreign tax credits for interest on loans with withholding tax rates of 5% or more. As it happens, many loans of LDC's bear withholding tax rates of 5 percent or more.

The motivating force behind the new foreign tax credit limitation rules was to prevent taxpayers from crediting withholding taxes on cross-border loans against other lower taxed foreign source income. The theory seemed to be that this would not cause banks economic hardship because the tax burden of high withholding taxes allegedly "falls largely, in the typical situation, on the foreign borrower rather than on the U. S. lender." S. Rep. No. 313, 99th Cong., 2d Sess. at 304 (1986). I find fault with this latter assumption.

To the degree that a bank cannot credit its withholding taxes, its economic burden of taxation will exceed the highest U. S. marginal rate of tax. Consequently, when the withholding taxes paid to a foreign government

are added to the U. S. taxes paid on its income, banks with excess foreign tax credits will pay substantially more taxes in total than competitor institutions not having cross-border loans. This is a real economic burden on the banks. And, contrary to the quoted statement above, it is not a burden that foreign debtors, particularly LDC's, are very likely to assume.

The effect of the new foreign tax credit limitation on high withholding taxes will put most U. S. banks involved in cross border lending to high withholding tax countries into an excess foreign tax position beginning late in this decade. Obviously, this will then be a significant disincentive for such banks to extend new loans to LDC's as they are typically high withholding tax countries.

ly all of those projections depend upon a more substantial improvement in the trade account than we actually think is possible.

We believe the exchange rates at current levels therefore are not likely to do the job.

Second, we would like to point out that the administration has identified other steps to be taken other than exchange rate adjustment and we agree with that. Most important in that respect is more rapid economic growth abroad.

Unless there is a major improvement in domestically generated growth in Western Europe and in Japan, there is no practical way to export our way out of this situation. Perhaps I can illustrate that with a simple statement.

Our imports are now roughly twice our exports. In order to hold the trade balance even at this very unsatisfactory level, exports have to grow twice as fast as imports. And you don't get an improvement in the trade balance until they are growing more than twice as fast as imports.

Historically, that situation has not prevailed in the United States in the postwar period, except for a quarter or two. This has serious implications because if you can't accomplish the trade improvement on the export side, the pressures to do so with import restrictions perhaps become inexorable.

Third, we would like to urge and have done so—urge the Treasury to take a more aggressive stance with respect to those countries whose currencies have hardly moved at all with respect to the dollar. That's most notably Taiwan and Korea, but there are other countries in that category and Canada is in that category also, although there are some special problems and considerations to be taken into account in that regard.

Finally, we would like to refer to what took place at the Paris meeting having a bearing on longer range steps to reform the international monetary system.

The present lack of a system obviously is very harmful to U.S. trade interests. Unless a higher degree of confidence can be established in the system that the system itself can establish and maintain reasonable rates of exchange, the necessary increase in capacity for industrial production in the United States is placed in jeopardy.

Paul Volcker has indicated that in order to right our current account balance we will have to achieve roughly balance in the trade account, or a surplus. That calls for an expansion of the U.S. manufacturing base by as much as 30 percent. It's very unlikely that American firms are going to expand the capacity in the United States for export in the face of the rollercoaster exchange rate system that now exists around the world.

It's not in the interest of American manufacturing to have a lot of overshooting on the downside, making our goods very competitive for a while, only to have the redress in the trade account and the current account bring about a higher value of the dollar and a repeat of the performance of the 1980's.

I would like to urge this committee to consider hearings on the direction of international monetary reform. At this time it's really a matter perhaps of options and alternatives. Bob Heller of the Federal Reserve recently suggested the possible use of a commodity

standard. Some of us have some confidence in the possibility of a flexible system possibly employing target zones or reference zones. There are a few gold bugs here and there. But unless attention is focused on the longer term and a system that offers greater stability at reasonable rates, I think we are making it very difficult both to solve the trade situation we have now or to achieve the degree of increased investment and production that we need in the manufacturing sector to accomplish that result.

OVERSIGHT OF EXCHANGE RATE DEVELOPMENTS

I would hope that this committee in connection with its contribution to the Senate's omnibus trade bill would put in a good provision with respect to congressional oversight of exchange rate developments. The House has done that. You've seen what they've done and we would support that. I am not myself of the opinion that all the features of the House bill are appropriate, particularly the requirements to estimate a competitive exchange rate. It may be unrealistic to hold the Treasury's feet to the fire as to why a rate is a reasonable one or why it wasn't achieved. But serious oversight functions by this committee and the Congress generally is absolutely essential.

It's obvious that the exchange rate subject is not so arcane that only the Treasury and the Federal Reserve can understand it. In my opinion, if the Congress had pursued the exchange rate subject more avidly in the period from 1981 to 1985, the Treasury would not have been able to get along as long as they did with substantively poor or propagandistic explanations as to why the macho dollar was a good idea. And, of course, we are paying the price for that now.

Mr. Chairman, in addition to the testimony which I know you will make part of the record, we recently wrote a letter to the Secretary of the Treasury summarizing some of these points and I would request that that letter also be made a part of the record.

Senator SARBANES. That will certainly be included in the record. Thank you very much, Mr. Fox.

[The complete prepared statement of Lawrence A. Fox follows:]

SUMMARY OF TESTIMONY

Lawrence A. Fox
NAM Vice President, International Economic Affairs
National Association of Manufacturers

Exchange Rates and the U.S. Trade Deficit
International Financial and Monetary Affairs Subcommittee
Senate Committee on Banking
April 2, 1987

Impact of the falling dollar on U.S. trade. Despite the fall in the dollar over the past two years, the U.S. trade balance has worsened to a record \$170 billion deficit. The failure of U.S. manufactured exports to increase significantly is especially disappointing. These developments confirm our view that other supportive policy actions are needed, such as appropriate budget and monetary policies, encouragement of more growth abroad and measures aimed at opening foreign markets, as well as further actions in the area of exchange rates.

Exchange rate policy following the Paris Agreement. Our comments represent NAM's view of the Paris "G-7" agreement, in light of the earlier recommendations of the NAM Task Force on International Monetary Affairs:

- o We are apprehensive that the huge U.S. trade imbalances will not be sufficiently reduced at current exchange rate levels. We understand the policy reasons for the pause in the fall of the dollar agreed at Paris, but suggest a review of exchange rate levels if desired current account changes are not forthcoming.
- o NAM recognizes that currency adjustments alone are not enough to correct present trade imbalances and continues to support strongly the Administration's efforts to encourage more growth-oriented domestic policies among our major trading partners.
- o NAM would also like to see a more aggressive stance by the Treasury Department in efforts to encourage appreciation of the currencies of Taiwan and Korea. This would include direct bilateral actions and multilateral reviews, as discussed in the Paris Agreement.
- o NAM believes that it is essential to work toward an improved global exchange rate system, that more adequately reflects trade competitiveness. The Paris Agreement to represent progress in this direction, but we believe such a system should go beyond the current practice of informal G-7 consultations.

Legislative Action. NAM continues to support action in both Houses to establish an enhanced system of congressional oversight over exchange rate policy. This would include regular high-level reports by the Treasury Department and the Federal Reserve Board in a broader context than the present retrospective quarterly reports on official exchange market operations.

TESTIMONY OF
LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS

ON
EXCHANGE RATES AND U.S. TRADE
BEFORE THE
UNITED STATES SENATE
SUBCOMMITTEE ON INTERNATIONAL FINANCE & MONETARY POLICY
OF THE
COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

APRIL 2, 1987

Mr. Chairman and members of the Subcommittee, I am Lawrence A. Fox, Vice President for International Economic Affairs of the National Association of Manufacturers. I am pleased to be here today to discuss recent developments in the dollar exchange rate and U.S. policy in this area.

The National Association of Manufacturers is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 smaller manufacturing firms, each with an employee base of fewer than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods.

I would like to focus on these issues this morning:

- o The impact of the falling dollar exchange rate on U.S. trade
- o Exchange rate policy following the recent "Paris Agreement" of the G-7 nations
- o Long-term reform of the global exchange rate system
- o The appropriate role of Congress, especially with reference to exchange rate provisions in omnibus trade legislation.

IMPACT OF THE FALLING DOLLAR ON THE U.S. TRADE DEFICIT

With the dollar exchange rate falling for most of 1985, most analysts believed that there would be some improvement in the U.S. trade deficit last year. But the decline in the dollar exchange rate since 1985 has not so far led to an overall decline in the U.S. trade deficit, which was \$170 billion in 1986. The overall trade deficit reflects principally the deficit in manufactured goods of \$145 billion, that is 85% of the total deficit.

A major factor contributing to the worsening of the U.S. trade deficit by over \$100 billion between 1981 and 1985 was the unprecedented rise of the U.S. dollar exchange rate, despite the worsening of the U.S. balance of payments on current account. Reversal of the dollar's rise was an indispensable step toward correcting the deficit and this policy was repeatedly urged by NAM before the G-5 Plaza Hotel agreement of September 1985. But we have never said that the correction of the dollar's exchange rate alone would be enough, nor that its impact would be instantaneous. Correction of the exchange rate will only succeed in reducing the trade deficit in the context of correction of the budget deficit, appropriate monetary policy, adoption of sound competitiveness

policies, and a more aggressive and consistent trade policy especially aimed at opening foreign markets. Another year may be required to determine the full impact of dollar devaluation and associated G-5 macroeconomic policy coordination on U.S. trade.

When we look at our 1986 trade deficit by region, we can see that the pattern of the dollar's fall has had a strong influence. The G-5 agreement of 1985 to reduce the dollar exchange rate may have already had some favorable impact on U.S. exports to Europe. Our 1986 exports to the European Community were up by 9 percent, after having fallen since 1981. The dollar value of imports from the EC rose at an even higher rate (11 percent), but we would expect this initial reaction after a dollar devaluation. Of course, the dollar has also fallen substantially against the yen, and we have not seen strong export growth to Japan -- our 1986 exports were only 5 percent higher than in 1985, if we exclude an exceptional \$3 billion in re-exported gold. Because imports from Japan rose a further 18 percent over 1985, our trade deficit with Japan has expanded to \$60 billion. Overall, about \$13 billion of the net \$21 billion worsening of the total U.S. trade deficit is explained by trade deficit increases with the EC and Japan, and much of this is due to the "J-curve" effect on import prices.

In other regions of the world, there has been no overall depreciation of the dollar exchange rate since early 1985. Prices of consumer goods from the East Asian newly industrializing countries (NICs) have notably remained low, and our imports overall increased 16 percent from this region in 1986. And even though our exports were up by 9 percent to this group of countries, our deficit worsened by almost \$6 billion, to \$34 billion.

Elsewhere, the key to the trade situation was local growth prospects, because the dollar value of local currencies did not appreciate substantially. Little improvement in U.S. export performance has occurred in countries with relatively low growth rates. In Mexico, the OPEC nations and the developing countries of Africa and South Asia, both U.S. exports and imports have fallen, and the trade deficit has stayed about the same. Also, in trade with Canada, U.S. imports and exports were both down, leaving the U.S. balance a further \$1.3 billion in deficit.

Latin America -- excluding the oil producing countries of Mexico, Venezuela and Ecuador -- provides the only case where an overall increase in U.S. exports (16 percent) actually contributed to a significant reduction in the trade deficit in 1986 (almost \$2 billion). This change was due largely to increased U.S. exports to Brazil. But U.S. exports to the non-oil Latin American countries are still running over \$3 billion below the 1981 peak.

NAM POLICY RECOMMENDATIONS

In view of the continued growth of the U.S. trade deficit, uncertainty about the future course of U.S. exchange rate policy and our concern about the future of international monetary reform, NAM formed an international monetary affairs task force to review these issues last year. This group has presented an initial report to the NAM Board of Directors. I would like to summarize here the major policy recommendations of this task force, and include the full report with my testimony.

- o A further appreciation of the major industrial country currencies will be necessary to improve the U.S. trade balance, but we also need more growth abroad, especially in Germany and Japan, to eliminate current account imbalances and reduce worldwide reliance on exports to the U.S. market.
- o More than half of all U.S. trade is with countries whose currencies have not substantially appreciated against the dollar. The currencies of the East Asian NICs, notably Taiwan and Korea, have appreciated somewhat in recent months, but do not reflect their major trade surpluses with the U.S. and have actually fallen against other major currencies, placing competitive pressures on other manufactured goods producers. Some way must be found to link these currencies systematically to the international monetary system, so their exchange rates more closely reflect current account performance. One possible policy option may be to link their currencies with the SDR rather than the dollar, following an appropriate significant appreciation of their currencies against the dollar. In the meantime, increased U.S. bilateral pressure seems to be the only tool available.
- o While it may be premature to prescribe an exact formulation for reforms in the international monetary system, more structure in the exchange rate system is required as well as a more formal process for relating exchange rates to economic fundamentals than the "G-7" consultative process that evolved in 1985-86.

In turning to a discussion of the present U.S. exchange rate position and the recent Paris discussions, I want to indicate our view that the Paris agreement seems to represent progress in exchange rate coordination. However, difficult conditions in exchange rate markets have developed in recent weeks and I would like to comment on this subject in the course of this testimony.

RECENT EXCHANGE RATE DEVELOPMENTS AND THE PARIS AGREEMENT

Before I look more closely at the Paris Agreement, I would like to discuss for a moment the general impact of the signals that governments give to exchange markets. A number of prominent economists have recently said that the Plaza Agreement of 1985 had little to do with the fall of the dollar, which had already started down on exchange markets and just continued at the same rate after 1985. I would strongly dispute this view. A detailed look at the evidence shows that the dollar actually strengthened in the weeks just before the Plaza Agreement, and only resumed its sharply downward curve after the governments initiated a more active policy of coordinated intervention. I am not saying that the dollar only fell because of government intervention -- but I am saying that governments played a critical role in consolidating and supporting this downward trend. What governments say and do is part and parcel of market information, perceptions and actions respecting currency values. When the U.S. government abandoned its hands-off policy toward the value of the dollar, it affected the market processes in a profound way.

In a similar vein, the Paris announcement of February 22 clearly slowed the dollar's downward movement after the beginning of the year. A look at the table I have inserted in the text will quickly confirm this point.

Changes in the Value of the U.S. Dollar
Against Major Industrial Country Currencies
January-March 1987

	G-10*		Yen		DM	
	Rate	% Chg.	Rate	% Chg.	Rate	% Chg.
Jan. 1, 1987	103.79	-	158.30	-	1.9235	-
Feb. 20, 1987	99.59	-4.0	153.65	-2.9	1.8280	-5.0
Mar. 20, 1987	98.82	-0.8	151.70	-1.3	1.8345	+0.4
Mar. 31, 1987	-	-	145.83	-3.9	1.8063	-1.2

*(March 1973=100)

From January 1 to the Paris meeting, the dollar fell 4 percent against the complete G-10 index. It dropped 5 percent against the DM alone, and almost 3 percent against the yen. The announcement in Paris that the finance ministers and central bank governors would cooperate to "foster stability around current levels" put on the brakes for about a month. The dollar fell less than 1 percent overall in the month after Paris, less than 1.5 percent against the yen and actually rose slightly against the Deutsche mark. These figures were well within the margin of daily swings in recent years, so essentially the dollar was close to stable after Paris. The dollar renewed its fall over the past week, and broke the 150 yen barrier again, amid reports of countervailing intervention by the Fed, as well as foreign monetary authorities. As of

yesterday, it was still not clear the degree to which G-5 members were committed to holding the dollar at present rates through market actions, but evidence so far indicates continued cooperation to this end. The most interesting question is whether or not they will succeed, and if so, at what cost.

What is our response to the impact of the Paris Agreement at NAM? Earlier this week, we commented on the Paris Agreement in a letter to Secretary Baker, which I would ask be included with my testimony. I would like to elaborate here the points made in that letter.

--Is the Exchange Rate at the Right Level Now?

We are apprehensive that the huge U.S. trade imbalances will not be sufficiently reduced at current exchange rate levels. However, we do recognize that the movements in the exchange value of the dollar with the currencies of several of our major trading partners have been large and may be slowly bringing about the shifts in trade volumes that are necessary for the health of American industry. Having gone through the process ourselves, we understand concerns abroad that rapid currency appreciation may cause radical changes in the operating environment beyond the control of management, no matter how productive or efficient the individual enterprise. And certainly, the fall of the dollar overall since early 1985 has been as fast and well ordered as we could have reasonably expected against the major industrial country currencies. But while we recognize a pause in the dollar exchange rate's downward adjustment as possibly appropriate at this time, the bottom line will be the impact in improving U.S. trade performance and shifting current international trade imbalances. If such shifts are not forthcoming, we

have strongly suggested that the U.S. government reconsider the appropriateness of supporting the exchange rate at current levels

--The Need for More Growth Abroad

We recognize that currency adjustments alone, are not enough to correct present trade imbalances. NAM has strongly supported the Administration's efforts to encourage more growth-oriented domestic economic policies among our major trading partners. We therefore urged the Secretary of the Treasury to see that the other participants in the Paris Accord, particularly Japan and Germany, implement the policy changes to which they are committed and thereby expand the markets for U.S. products. NAM's Board of Directors has a formal statement of policy on the importance of accelerated foreign economic growth.

--Currencies of the Newly Industrializing Countries

The NAM would also like to see a more aggressive stance by the Treasury Department in efforts to adjust the large U.S. trade imbalances with Taiwan and Korea. We believe that further meaningful appreciations of their currencies and a more open trade and investment climate in those countries can come about only through increased pressure from the Treasury Department and other agencies of the U.S. government. We are pleased that the G-7 countries have officially taken cognizance of this problem. We support continued multilateral review of the issue of appreciation of the pegged currencies of the highly competitive NICs. Since the Plaza Agreement in September 1985, the new Taiwan dollar has appreciated 18 percent, while the Korean won is now at roughly the same level as in late 1985.

--Reform of the International Monetary System

Finally, as our task force report indicated, we think it is essential to work toward an improved global exchange rate system, one that more adequately reflects trade competitiveness. This goal, along with greater stability of exchange rates at realistic levels, is a subject of great importance to our members. Future healthy growth in the manufacturing sector in the United States is conditioned to a major degree on achieving an improved worldwide exchange rate system. We know that the President has charged the Treasury with this important assignment. We look forward to achievement of this long-term goal, and view the recent Paris meeting as progress in this context.

Referring again to our report, I would like to note here for your consideration our views at present on the evolution of the international monetary system.

Over the long run it will probably be necessary to replace ad hoc consultations -- even based on "objective" fundamental indicators such as current account balances, growth rates, inflation and budget deficits -- with some more systematic approach. But at present it is premature to prescribe a more precise approach to international monetary reform. We would say that consideration of longer term reform should take into account:

- o The actual degree of success of the "G-5" effort in correcting the misalignment of the dollar that had developed in 1981-85, particularly through cooperation in currency intervention.
- o The lack of success among the "G-5" countries in achieving a higher degree of macroeconomic coordination.

- o The need to incorporate non "G-5" currencies more fully into a global monetary system, especially currencies of the Far Eastern NICs.
- o The need to insure that relative currency values express current account movements over the long term.
- o Practical results achieved by the International Monetary Fund's surveillance through use of quantitative economic indicators.

We are now in an environment of global financial markets in which movements of capital are both highly volatile and less responsive to traditional considerations of trade or current account balances. One of the consequences, of course, is less certainty and less control over monetary policy on a national basis. Interest rate volatility tends to be dampened, and exchange rate volatility heightened. One result, as we know from our experience in this country in the 1980s, is that the goods producing sectors -- especially export and import sensitive sectors -- bear the brunt of the adjustment process, rather than the interest-sensitive sectors that carried the burden in the past. Monetary policy therefore must be directed at both domestic considerations and international considerations, and the exchange rate increasingly is the bridge between the two.

Efforts to improve the functioning of the international monetary system -- exchange rate system reform in other words -- must therefore take into account the monetary aspect of policy coordination among major countries, as well as other elements of macroeconomic policy, particularly fiscal policy. Multilateral surveillance by the International Monetary Fund of macroeconomic coordination among countries has a role to play, as well exchange rate surveillance.

Beyond improved macroeconomic coordination and multilateral surveillance by the International Monetary Fund, there is need to take a hard look at reasons to introduce and maintain a higher degree of structure in the exchange rate system. For example, target zones in one form or another could be considered. Also, central rates might be registered with the IMF by all members in a position to do so, including the Asian NICs and Taiwan (a non-member). A process of public discussion of alternatives should be started in earnest, working toward total reform of the system or partial reform initially among major countries. The criteria of trade competitiveness and current account positions must play a central role. Our objective, of course, is not to achieve more stable exchange rates at any value--but to do so at rates commensurate with our objective of improving U.S. prospects for employment, growth, and standard of living. And, of course, these exchange rates should be compatible with and facilitative of growth and stability in the highly interdependent world economy.

Higher priority for international monetary reform is essential, and day-to-day efforts along the lines indicated should reflect this longer-term view.

LEGISLATIVE PROPOSALS

I understand that there is no specific legislative language before this subcommittee today, but that you may make new proposals in the near future, for possible inclusion in an omnibus trade bill.

Last year, this committee did report a proposal requiring regular written and oral reports to Congress by the Secretary of the Treasury and the Chairman of the Federal Reserve Board, on the exchange rate

developments and U.S. government action, including the impact on U.S. trade, the current account and our overall economy. In my opinion, this is an important initiative that, in effect, would require this country to have a stated exchange rate policy. This proposal was reported by the committee in 1986 for inclusion in an omnibus trade bill, with bipartisan support.

We would strongly support inclusion of such a provision in a general trade bill. As I indicated in testimony in the last Congress, it is not possible or appropriate for Congress to attempt to control directly official actions designed to influence the exchange rate, but it certainly has a very proper role in overseeing such actions. At present, the Federal Reserve Board does report retrospectively every quarter on its exchange market operations, but these reports focus solely on technical matters. There is little effort to place these actions in the context of broader economic policies. Had the broader, high-level reporting requirement been in place in the early 1980s, for example, I believe it would have been politically more difficult for the Treasury and the Federal Reserve to ignore exchange market options when the dollar soared as the trade and current account deficits worsened.

We have noted that the trade bill now before the Senate Finance Committee, S. 490, includes language directing the President to engage in negotiations with the "pegged currency" countries on their effectively under-valued exchange rates. We also believe that it is appropriate for Congress to address this issue by way of encouraging the types of direct bilateral actions outlined above.

January 27, 1987

NAM INTERNATIONAL MONETARY AFFAIRS TASK FORCE
INTERIM REPORT

Presented to NAM Board of Directors
International Economic Policy Group
February 5, 1987

INTRODUCTION AND EXECUTIVE SUMMARY

Finally, I would like to urge the Congress to begin the process of helping to develop ideas for reform of the international monetary system. New ideas are needed, as well as systematic evaluation of the results achieved by means of the reform steps outlined above. Hearings and discussions are required. Big mistakes were made when the Treasury had a blank check on currency matters. Our country will be paying the bill for the consequences for the rest of the century and beyond. To achieve our national goal of increased competitiveness nothing is more important than a properly functioning international exchange rate system that puts a reasonably correct value on the dollar.

The NAM International Investment and Finance Committee established on September 22, 1986 a task force composed of committee members to study recent developments in the international monetary system, their impact on U.S. trade and investment, and prospects for a long-term reform of the system (a list of task force members is attached to this report). This report provides an updated assessment of recent developments relating to the dollar exchange rate and its impact on trade. It presents the task force's views on the most immediate needs from the U.S. perspective, as well as the prospects as we now see them regarding long-term reform.

The first part of the report analyzes the present U.S. trade and current account position. The decline in the dollar exchange rate since 1985 has not so far led to an overall decline in the U.S. trade deficit, which will be over \$170 billion in 1986. The overall trade deficit reflects principally the deficit in manufactures which could reach \$140 billion, and has increased over the past year with most of our major trading partners. There is some evidence that the falling dollar is exerting a positive influence on U.S. trade - notably increased exports to Europe and a rise in recent months in the volume of capital goods exports.

But this turnaround is not strong enough to have a major impact on the current account balance. An ominous but not unanticipated aspect of the present situation is that non-trade factors in the balance of payments are turning increasingly negative, particularly as a result of interest and other payments on our growing international indebtedness. This means a current account deficit of perhaps \$140 billion this year, and of potentially the same level in the future, unless the trade deficit is reduced close to zero. Already the consequences of the present deficit are a net U.S. foreign indebtedness in the range of \$500-\$800 billion by 1990 on present trends. A debt of this magnitude could mean a substantial reduction in the U.S. standard of living.

Consequently, a key objective of U.S. economic policy should be to reduce the trade deficit, and thereby achieve a balanced current account. Further, if we are to reduce our foreign indebtedness, we will ultimately need a current account surplus. While recognizing that we should not rely on exchange rate changes alone to reverse the trade deficit, the report focuses on such changes, as well as changes in the international monetary system:

- A further appreciation of the major industrial country currencies will be necessary to improve the U.S. trade balance, but we also need more growth abroad, especially in Germany and Japan, to eliminate current account imbalances and reduce worldwide reliance on exports to the U.S. market.
- More than half of all U.S. trade is with countries whose currencies have not substantially appreciated against the dollar. In particular, the currencies of the East Asian NICs, notably Taiwan and Korea, have not reflected their major trade surpluses with the U.S. and have actually fallen against other major currencies, placing tremendous competitive pressures on all other manufactured goods producers. Some way must be found to link these currencies systematically to the international monetary system, so their exchange rates more closely reflect current account performance. In the meantime, increased U.S. bilateral pressure seems to be the only tool available.
- While it may be premature to prescribe an exact formulation for reforms in the international monetary system, we probably need some more formal process for relating exchange rates to economic fundamentals than the present "G-7" consultative process that evolved in 1985-86.

1. THE IMPACT OF A DECLINING DOLLAR ON U.S. TRADE AND THE BALANCE OF PAYMENTS, 1985-86

The "G-5" initiative to reduce the exchange value of the U.S. dollar, agreed at the New York meeting of September 1985, has proved to be a major technical success. Although the dollar had started to fall from its February 1985 peak, this agreement consolidated its downward direction. Between February 1985 and the period immediately prior to the European Monetary System realignment in January 1987, the dollar fell 34 percent against the Federal Reserve's weighted index of major industrial country currencies. The fall was nearly 40 percent against the yen (from 260 to 158), and 42 percent against the Deutsche mark (from 3.30 to 1.92). During the week of January 15, following the EMS realignment, there was a further sharp downward move of the dollar -- to DM1.83 and ¥152, for example, accompanied by speculation that further substantial weakening of the dollar was possible.

Of course, there has been much criticism that the "G-10" index and the movement of the dollar against other major industrial country currencies do not adequately reflect the bilateral trade patterns of the United States. It is argued that these measures overstate the fall of the exchange rate and exaggerate the impact on trade. We will look at this point in more detail in the next section. But in any case it is interesting that even the "G-10" index was still about 4 percent higher in mid-January 1987 than its March 1973 base, when the U.S. dollar was floated. This means that even against industrial country currencies, the present value of the dollar does not reflect our real competitive position.

Worsening Trade Deficit

Despite the falling dollar, the U.S. trade deficit and the overall deficit in the balance of payments on current account have increased to record levels. Based on figures through November 1986, the annual U.S. trade deficit (imports c.i.f.) for 1986 will be \$170-175 billion. This is about \$25 billion higher than the 1985 record deficit. All of this increase was in manufactures, where the deficit increased to almost \$140 billion, compared to a 1985 deficit of \$113 billion. These figures compare to a manufactures trade surplus (\$5 billion) as recently as 1981, and an overall trade deficit of about \$40 billion at that time.

The worsening of the U.S. trade deficit in 1986 occurred with most of our major trading partners:

- The bilateral U.S. deficit with Japan worsened by \$10 billion, from \$50 billion in 1985 to an annual rate of \$60 billion. U.S. imports were up 20 percent to over \$86 billion. U.S. exports were up \$4 billion to \$27 billion, but this net increase was mostly all due to an exceptional gold re-export arrangement in mid-summer.

- The bilateral deficit with our largest single trading partner, Canada, increased less dramatically -- by about \$2 billion to \$24 billion (annual rate). U.S. imports were virtually the same as in 1985, but exports fell nearly \$2 billion. On exchange markets the Canadian dollar is marginally stronger today against the U.S. dollar than it was in early 1985. To some extent this is due to official Canadian currency intervention.
- By contrast, U.S. exports grew fairly strongly to the 12 European Community countries, but imports were up even more, and our deficit with this group worsened by over \$4 billion to nearly \$27 billion. More than half this deficit is accounted for by Germany, with which we had a deficit of nearly \$16 billion in 1986, compared to under \$12 billion in 1985.
- With the East Asian region (excluding OPEC member Indonesia), our deficit worsened by over \$6 billion, to \$34 billion. Most of this deficit is accounted for by Taiwan (U.S. deficit - \$16 billion) and Korea (U.S. deficit - \$7 billion). The currencies of these countries have not shared in the strong appreciation against the dollar, and this in particular has encouraged a continued high rate of U.S. import growth.
- Latin America (excluding OPEC members) was the major geographical region where our balance actually improved somewhat. Although our exports to Mexico fell by over \$1 billion, our imports declined even more, and our deficit was reduced by \$700 million to \$5.1 billion. Our exports to the rest of the region, notably Brazil, grew strongly (up 16 percent) and our imports were level, so the deficit with these countries narrowed by nearly \$2 billion.
- Despite savings on oil imports, our deficit with the OPEC countries showed little change, because our exports also fell. The annual rate 1986 U.S. deficit of \$11 billion was only a slight improvement over 1985.

To some degree this initial worsening of the trade deficit during a period of dollar depreciation is to be expected, especially as a continuing fall of the dollar has stretched out the "J-curve." That is, the rising dollar price of imports affected by exchange rate changes worsened the trade balance before the impact on U.S. export prices stimulated our exports. Moreover, the large federal budget deficit has continued to stimulate domestic demand, including demand for imported goods, while U.S. tax law changes appear to have stimulated a temporary surge of imports at the end of 1986, in anticipation of the elimination or reduction of many business deductions in 1987. And there is some positive news as capital goods

export volume has shown a responsiveness to the exchange rate change since mid-1986, exhibiting a 4 percent higher average monthly rate than in the previous 18 months.

Even allowing for a lag in response to exchange rate adjustments, prospects do not look good for either a rapid or decisive improvement in the trade deficit. For example, it has been estimated that the improvement in 1987 and 1988 could be on the order of \$20 to \$30 billion per annum, an amount that would do little to reduce the overall deficit in the balance of payments on current account, because of increased debt service associated with our growing international debt. The decline in the dollar exchange rate will eventually exert downward pressure on the trade deficit. But there is considerable doubt regarding the timing of the impact of the exchange rate change, and little doubt that the change so far will be insufficient to bring the trade account even roughly into balance. The decline of the dollar must not only continue, but should also occur against a broader spectrum of trading partner currencies -- not just the major industrial country currencies. Even assuming success in such efforts, it is clear that redress of the payments imbalance without undue harm to the world economy will require significant progress in measures to stimulate growth abroad, improve U.S. access to foreign markets, and ameliorate the Latin American debt situation.

The Rise in the Current Account Deficit and the Growth of National Foreign Indebtedness

It will become more and more difficult to balance our overall current account, which includes merchandise trade, services and investment earnings, without eliminating the trade deficit. For example, as recently as 1981 our nation actually recorded a net current account surplus of \$6 billion -- because of net earnings on investments and services -- despite the large trade deficit. Yet as our trade deficit and our federal budget have both grown larger, we have attracted increasing inflows of foreign capital which have created a growing repayment burden that is reflected in the current account.

Thus, the overall current account balance worsened, even despite a record level of U.S. direct foreign investment earnings at an annual rate of \$40 billion in the first three quarters of 1986. Dollar earnings from abroad were boosted by the falling exchange rate and higher growth rates in some areas. Nevertheless, the net U.S. surplus on all types of investment earnings in the current account (direct, portfolio and government investments) was \$23 billion in the first three quarters of 1986, compared to \$31 billion in 1979, the previous record year for direct investment earnings from abroad.

Moreover, no other area of the U.S. current account balance -- notably business services -- has shown any improvement sufficient to offset the massive increases in the merchandise trade deficit. Because of growing payments to foreign owners of dollar assets, the surplus outside of merchandise trade is expected to shrink and even to

fall into deficit possibly in 1987 or 1988. The following figures show how other factors in the balance of payments have offset less of the growing deficit in "visible" trade in the 1980s:

	Balance of Payments on Current Account	Merchandise Trade Balance ("B.O.P. Basis")
1980	\$ 2 bil.	-\$ 26 bil.
1981	6	- 28
1982	- 9	- 36
1983	- 47	- 67
1984	- 107	- 113
1985	- 118	- 124
1986 - 3 qtrs., annual rate	- 140	- 146

As the current account deficits continue, the United States' role as a net foreign debtor increases. Prior to this decade, of course, the United States was the world's largest creditor nation, and had been since the First World War. By 1985, successive large current account deficits quickly pushed the United States into net debtor status, and at some point in 1986 we became a larger net debtor country than Brazil or Mexico (over \$100 billion). Given the continued high level of the trade deficit, our net foreign indebtedness will increase by 1990 to a range possibly between \$500 billion (the minimum estimate of Gerald Corrigan, President of the New York Federal Reserve Bank) and \$800 billion (according to IMF estimates).

No one really knows what the impact of this foreign indebtedness will be. For example, Martin Feldstein, former Chairman of the Council of Economic Advisers, has predicted a rapid turnaround of the trade and current account deficits in the 1990s, as the "unsustainable" levels of the deficits cause a rapidly falling dollar. Such a quick "correction" would not be without serious costs, as he calculated in a December 1986 speech: "...The deterioration in the U.S. terms of trade and the increase in overseas debt service could reduce the annual rate of increase of real income in the United States over the next five to ten years by between half a percent and one percent a year...This is equivalent to losing between one-half and one-fourth of our historic rate of income growth."

The dangers inherent in the rapid increase of U.S. foreign debt can only be obviated through a strategy to reduce the current account deficit and to end gradually the build-up of the U.S. position as an international debtor. This means that the trade deficit must be substantially reduced, even if it is not yet possible to set a target date for a "zero" trade balance, or envisage all of the conditions necessary to bring it about. Clearly these conditions must include a

decline in the exchange rate of the dollar that will enhance the competitive position of U.S. industry.

Other Policy Measures Are Needed

A reduction in the dollar exchange rate implies a reduction in U.S. demand for foreign goods relative to U.S.-produced goods. The adjustment in the U.S. trade deficit through changes in exchange rates can be facilitated -- and negative aspects of the adjustment diminished -- if appropriate policies are adopted by government and business:

- Reduce the federal budget deficit -- this would reduce the government's absorption of the nation's savings and offset the reduction of capital inflows;
- Restructure national tax and savings strategies to increase the overall savings rate;
- Improve national productivity performance.

This point reinforces our clear message that the trade deficit now plays an enormous role in our national economy and that all national economic policies must be reassessed with respect to their impact on the trade balance. Exchange rate policy is necessary to reduce the trade deficit. But appropriate macroeconomic policies and policies to improve our competitive position are also needed.

II. IMPACT OF GLOBAL ECONOMIC DEVELOPMENTS ON U.S. TRADE PERFORMANCE

Present economic policies abroad, especially in Japan and Germany, remain insufficiently stimulative with respect to increasing the overall growth of world manufactured exports and industrial goods production. The reduction of the U.S. trade deficit will require a rapid growth in exports, especially of manufactured goods, and at least a standstill in U.S. import growth, if not an actual reduction of imports. Thus, other countries will not be able to continue their reliance on the wholly disproportionate growth in exports to the United States to support growth at home, as they have done so far in the 1980s. Whether such reliance has been encouraged by unwise U.S. domestic policies is beside the point. Most other governments share the view that the twin U.S. deficits -- in the federal budget and in our balance of payments -- must be corrected. To achieve this much-desired result, other countries will have to find increased growth in their own domestic economies and in export markets other than the United States.

Figure 1, which traces U.S., Japanese and German current account balances over the past decade shows that these other two countries have been the ultimate beneficiaries of the dramatic reversal in the U.S. international trade position. While our deficits have grown rapidly with almost every region -- as outlined earlier -- these two

highly competitive manufacturing economies have achieved totally disproportionate current account surpluses as a consequence of the world trade recovery.

The combined estimated 1986 surpluses of Japan (\$82 billion) and Germany (nearly \$50 billion) virtually equal the estimated U.S. deficit of \$140 billion. In 1976, by contrast, all three countries had surpluses of roughly \$4 billion, and over the ensuing five years, as the chart shows, their current accounts fluctuated in a fairly predictable cyclical manner which followed relative exchange rate changes.

The widening gap in balance of payments performance since the early 1980s is thus not likely to be closed without changes in the relative rates of GNP growth. In 1986, for example, the three major industrial economies all grew at around 2.5 percent. Under such conditions - and absent strong growth in other major economies - even the large depreciation of the dollar to date is unlikely to produce a sufficiently large current account balance correction.

As indicated in NAM's Board Resolution of September 1986, we believe that there is scope for increased growth stimulus in the other major industrial economies, particularly Germany and Japan. German growth is the key to improved economic performance within the entire EC, and the improvement of U.S. exports to this area already has been noted. With Germany's present large current account surplus, which could continue at nearly the same level through much of 1987, its surprisingly modest overall rate of growth, its high unemployment rate, its non-existent inflation and its relative lack of a structural budget deficit, there appears to be no reason why German policy should not be more stimulative of domestic growth. With proposed tax cuts in the pipeline, current high marginal rates of taxation and a high real interest rate, there appears to be no lack of policy options.

Japan presents a different situation, principally because of the relative lack of openness of its market. The rapid rise in the yen has reversed export volume growth and induced near-recession conditions in the Japanese economy. Yet because of rapid improvement in the terms of trade and the fall in imported energy costs, the Japanese current account surplus is now approaching the \$100 billion level. The rapid rise in the yen, from 158 per dollar to 152, in a few days after the EMS realignment, indicates the market's assessment that this currency remains undervalued in view of the massive current account surplus. While "market smoothing" operations may be desirable from a technical perspective, the yen should continue to appreciate, if only to reduce the Japanese current account surplus by reduced price competitiveness on the export side. But a far more sustainable solution, probably for Japan as well as its trading partners, is to combine a more open economy with a higher rate of domestically-generated growth.

III. NON-APPRECIATION OF SOME IMPORTANT CURRENCIES

More than half of total U.S. trade is now accounted for by countries with currencies that have not appreciated to any great extent against the U.S. dollar since January 1985. In some cases, notably Canada and the Far-East NICs, continued low exchange rates have meant a competitive advantage for them on the U.S. market. In the case of Far-East manufacturers especially, actual depreciation of their currencies against third country currencies has caused increasingly defensive policies in those markets and encouraged more intensive export efforts aimed at the United States. The sharp depreciation of East Asian NIC currencies against non-dollar major currencies has translated into rapid export growth and a strong surplus movement in current account balances: Taiwan, with a population of only 15 million, now has an overall current account surplus of \$20 billion, owing mostly, but not solely, to its large bilateral surplus with the United States.

Figure 2 provides a closer look at the behavior of the currencies of the two countries of principal concern, Taiwan and Korea, by measuring their indexed exchange rates bilaterally against the U.S. dollar and against the International Monetary Fund's SDR, which is used as a multilateral index. Since these currencies performed somewhat differently, we will consider them separately.

While the U.S. dollar fell from 1985 through the first half of 1986, the Taiwan dollar followed the U.S. currency rather closely. This was in keeping with the tradition of central bank pegging to the dollar. The Taiwan central bank continues its practice of requiring all earners of foreign currencies to sell these currencies to the central bank, which then holds them as reserves. Taiwan foreign currency reserves are now over \$40 billion -- the highest per capita reserves of any country.

Thus despite the further rise in the U.S. deficit from \$11 billion in 1984 to an annual rate of \$16 billion in 1986, the Taiwan dollar fluctuated within 3 percent of the U.S. dollar through the first half of last year. And after an initial rise with the U.S. currency against the SDR basket in early 1985, the Taiwan dollar fell steadily against this multilateral index. By the third quarter of 1986, it had lost 10 percent of its value against the SDR. Following an expression of direct U.S. government concern with the trade impact of a cheap Taiwan dollar, we saw some upward movement at the end of 1986. But the Taiwan dollar was still only 9 percent above its 1984 average against the U.S. dollar bilaterally, and remained 7 percent under its 1984 value against the SDR.

By contrast, Korea has substantially depreciated its currency against the U.S. dollar, and thus allowed it to fall even farther against the multilateral index represented by the SDR. The won dropped 10 percent against the dollar in 1985, and a full 18 percent against the SDR. This fall represents a government decision to devalue in the face of debt repayment pressures (total Korean foreign indebtedness is about \$40 billion) and a fall in the domestic growth

Senator SARBANES. It's very helpful to have this testimony. I'm sorry we weren't able to do it on the earlier hearing date.

Mr. Schecter.

**STATEMENT OF HENRY SCHECTER, DIRECTOR, OFFICE OF
HOUSING AND MONETARY POLICY, AFL-CIO**

Mr. SCHECTER. Mr. Chairman, I appreciate the opportunity to present the views of the AFL-CIO concerning the economic consequences of exchange rate movements or lack of movements upon the U.S. economy.

CONSEQUENCES OF EXCHANGE RATE MOVEMENTS

As U.S. interest rates rose during the latter part of 1980 and the first half of 1981, the international exchange rate value of the dollar began its long upward climb from a July 1980 low point. The United States had experienced a negative merchandise trade balance each year since 1976, but the trade deficit began to increase significantly as the exchange value of the dollar rose to higher levels.

The negative merchandise trade balance increased more than four-fold, from \$40 billion in 1981 to \$170 billion in 1986.

Beginning in 1985, there have been intermittent coordinated interventions in the international currency markets by Japan, Germany and the United States to bring the U.S. dollar, the Japanese yen, and the West German mark into a better alignment to bring about a reduction of the U.S. trade and current account deficits. These efforts have led to decreases of over 40 percent since early 1985 in the value of the dollar relative to that of the German mark and the Japanese yen. Against currencies of other countries, however, the dollar declines have been only about 10 percent.

The top seven bilateral U.S. trade deficits for 1986 accounted for almost three-fourths of the total U.S. trade deficit. Japan still had by far the largest trade surplus with the United States in 1986 and it was a substantial increase over the previous year. Even though the rise in the value of the yen had raised labor costs in Japan relative to those in the United States, the comparative labor costs in manufacturing in Japan were still only 71 percent of the United States in the third quarter of 1986.

West Germany also had a measurable increase in 1986 in its trade surplus with the United States as compared with 1985, but the absolute amount was smaller than Japan's. The increase was even smaller for Italy. Those three countries had significant depreciation of their currencies relative to the value of the dollar during 1985 and 1986. The 1986 comparable labor costs in Germany were comparable to those of the United States. In Italy they still equaled only 75 percent of the U.S. costs.

The other four of the top seven bilateral trade surplus countries in 1986 did not have any significant devaluation of their currencies. They all referenced their currency value to those of the U.S. dollar, even though they may not have a strict peg with the dollar.

Canada had the second largest bilateral trade surplus. The comparative labor costs in manufacturing in the third quarter of 1986 were about 83 percent of those in the United States.

Taiwan, with the third largest bilateral trade surplus, had a comparative labor cost of only 12 percent; South Korea, only 11 percent; Hong Kong, only 14 percent.

Even if the newly industrialized Asian countries had allowed the U.S. dollar devaluation to take place without revaluing their own currencies, letting their currencies float upward against the U.S. dollar to the extent that it was devalued would have required additional U.S. devaluations to begin to place those countries on a more level playing field.

We know, however, that Japan, and to some extent Germany, have already dug in against any further dollar devaluation because it would put their producers at a greater international price disadvantage.

The economic balance between production capacity and consumer demand that sustained a growing market in the United States does not prevail in the global economy the way it has been reshaped. In that connection, it should be noted that the heavily indebted developing countries, such as those in Latin America, have been forced under adjustment programs negotiated with the IMF and bank creditors to devalue their currencies in order to export more so as to have a positive current account balance large enough to meet debt service payments.

PROBLEMS OF CURRENCY DEVALUATION

However, their currency devaluation has also reduced their workers' real incomes and demands for U.S. products. Penetration of U.S. markets by foreign producers creates increased U.S. joblessness and lowering of wage scales which contracts the largest market in the global economy. Because of lower levels of wages and economic imbalances, the producers of other countries have to sell in United States and world markets that are less affluent than when workers producing the products received a better share of the sales value of the product. Sales volume benefits the economies of scale and profits for developing country producers all are reduced.

In a number of low wage countries there is a suppression of the rights of workers to organize and to engage in collective bargaining exacerbating the economic imbalances and slowing growth in the international economy. U.S. legislation is needed to define as an unjustifiable act the failure on the part of a country to take steps to adopt internationally recognized workers' rights as contained in title IV of the Trade Agreements Act of 1984. Failure to take such steps should result in the denial of the most favored nation treatment in trade as long as the country remained out of compliance.

The AFL-CIO strongly believes that competitive advantages in trade should not be derived from the denial of the right of freedom of association or refusal to assure a safe work environment, the absence of acceptable standards of minimum wages, the exploitation of child labor, etc.

It should be emphasized that the inclusion of these workers' rights and standards in U.S. trade law does not require the international adoption of U.S. practices. For example, accepted standards for a minimum wage does not mean the adoption of the U.S.

minimum wage, but the establishment of minimum wage machinery commensurate with a country's level of development.

Expansion of exchange rates of various countries cannot be considered in isolation. To deal with all the interrelated international monetary, trade, debt, and labor related matters, instead of relying on the pagentry of an annual economic summit with the big seven and a few special finance ministers' conferences during the year, there is a need for a continuous, combined, simultaneous negotiation on all these subjects to be carried on by high level, technically competent staff representatives of the countries involved. The U.S. staff representatives should be led by a special ambassador for international economic negotiations who would report back to the President frequently for instructions and the latter would, of course, have to approve any agreements. This would resemble the disarmament negotiations with Russia, but hopefully would prove more fruitful.

While economic peace may not be quite as critical as military peace, it is important enough to merit continuous negotiation.

Thank you.

[The complete prepared statement of Henry B. Schechter follows:]

rate in 1985. The won stabilized against the dollar last year, and began to register a rise in the last two quarters, which is continuing. But its two-year change was still a net 8 percent fall. And because of the dollar's own fall, the won has continued to decline against the other currencies in the SDR, reaching a 24 percent overall two-year drop by the last half of 1986.

The Taiwan and Korean currencies are expressed in terms of SDRs as well as dollars. We have done this in view of some support for the idea that these currencies might appreciate on their own in the short term, and then somehow be linked to the SDR. In any case, substantial appreciation of the Far East NIC currencies will be required in the near future, especially if we are to avoid further defensive trade policy reactions in the United States and in other major industrial countries. Of course, even a substantial appreciation will not eliminate the labor cost advantage maintained by these producers. But significant appreciation can moderate their super-competitive position in world markets.

The Canadian dollar has also moved up somewhat in recent weeks after a lengthy period of nominal depreciation against the U.S. dollar. Today the C-dollar stands at over 73 cents U.S., compared to a low of under 70 cents early in 1985. The Canadian government has justified a long-term fall in the exchange rate (from 85 cents in 1980, for example) because of an inflation rate persistently higher than in the United States. Nevertheless, the rapid expansion of the bilateral U.S. trade deficit over this period probably indicates a substantial competitive gain for Canadian producers. At the very least, we would expect no renewed lowering of the C-dollar exchange rate during the present period of intensive U.S.-Canada trade discussions. However, since Canada no longer has a global current account surplus and expects a deficit in 1987, resistance to C-dollar appreciation can be expected from Canadian authorities.

Finally, we should also note that all calculations of nominal exchange rate changes are virtually meaningless against the inflation and debt-plagued currencies of Latin America. A number of indicative real exchange rate calculations, however, have shown that producers from these countries have gained substantial advantages on world markets from exchange rate devaluations, even if we allow for domestic inflationary effects. We will consider this problem elsewhere, in development of a comprehensive NAM position on the Latin American debt problem and economic relations with the United States.

IV. INTERNATIONAL MONETARY REFORM

In his 1986 State of the Union message, President Reagan called upon the Secretary of the Treasury to prepare a report on the feasibility and usefulness of an international conference to consider international monetary reform. Indications at this time are that Secretary Baker will not present any comprehensive report in the near future, but that the Administration will cite the discussions at the

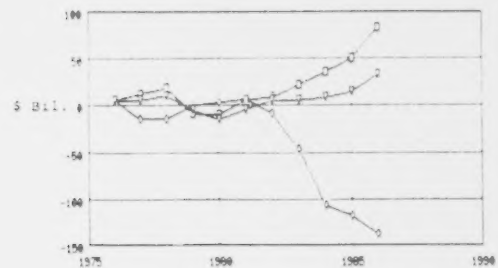
Tokyo Summit, the autumn IMF/World Bank meeting and perhaps the bilateral agreement with Japan as evidence that a new mode of international monetary cooperation is evolving. The recent further substantial fall in the dollar against all major industrial currencies can be used as evidence that this present informal consultative system is working in the U.S. trade interest.

We have already outlined our views on the substantive outcome of international monetary cooperation to date, and the impact on U.S. trade results. Over the long run it will probably be necessary to replace ad hoc consultations - even based on "objective" fundamental indicators such as current account balances, growth rates, inflation and budget deficits - with some more systematic approach. But at present it is premature to prescribe a more precise approach to international monetary reform. We would say that consideration of longer term reform should take into account:

- The actual degree of success of the "G-5" effort in correcting the misalignment of the dollar that had developed in 1981-85, particularly through cooperation in currency intervention.
- The lack of success among the "G-5" countries in achieving a higher degree of macroeconomic coordination.
- The need to incorporate non "G-5" currencies more fully into a global monetary system, especially currencies of the highly competitive Far Eastern newly industrializing countries (NICs).
- The need to insure that relative currency values express current account movements over the long term.
- Practical results achieved by the International Monetary Fund's surveillance through use of quantitative economic indicators.

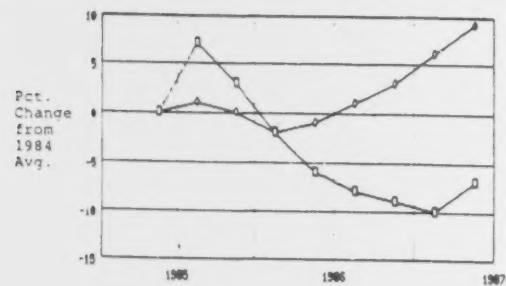
Higher priority for international monetary reform is essential, and day-to-day efforts along the lines indicated should reflect this longer-term view.

Figure 1: Current Account Balances - United States, Germany and Japan



Legend
 ◇ USA
 □ JAPAN
 ▽ GERMANY

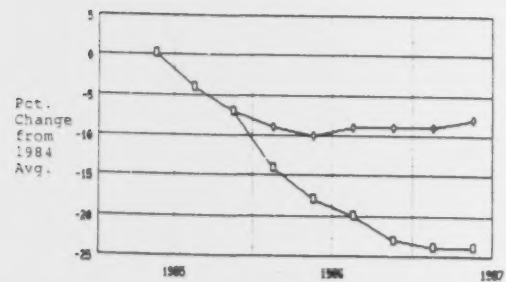
Figure 2: Changes in Korean and Taiwanese Exchange Rates, 1985-86



A. Taiwan Dollar

Legend

◇ SUS/SNT
 □ SDR/SNT



B. Korean Won

Legend

◇ SUS/WON
 □ SDR/WON

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Statement of Henry B. Schechter, Deputy Director, Economic Research Department
American Federation of Labor and Congress of Industrial Organizations
to the Subcommittee on International Finance and Monetary Policy,
Committee on Banking, Housing, and Urban Affairs, United States Senate,
on Exchange Rates and Third World Debt

April 2, 1987

We appreciate the opportunity to present the views of the AFL-CIO concerning the economic consequences of exchange rate movements, or lack of movements, upon the U.S. economy. While we recognize that the focus of the hearing is on the exchange rate policies of the newly industrializing Asian countries, we beg your indulgence to let us place those policies in focus with other interacting factors.

In July 1980, the U.S. dollar reached its lowest exchange value vis-a-vis the currencies of other major countries since the 1973 adoption of floating exchange rates. As interest rates rose again during the latter part of 1980 and the first half of 1981, the international exchange value of the dollar began its long upward climb. Although the inflation rate was reduced significantly in 1981 and 1982, interest rates were not reduced correspondingly, as a tight anti-inflationary monetary policy was maintained during 1981 and the first seven or eight months of 1982. Consequently, real interest rates -- after adjustment of interest paid in dollars for inflation -- actually rose.

The U.S. had experienced a negative merchandise trade balance each year since 1976, but the annual trade deficit began to increase significantly as the exchange value of the dollar rose to higher levels. Imports could come in at lower dollar prices, while U.S. exports had to be sold at higher local currency prices in

foreign countries. The negative merchandise trade balance rose more than fourfold, from a level of \$40 billion in 1981 to \$170 billion in 1986.

Since the trade balance is a major element of the U.S. international current account balance, the latter showed a deficit which rose from \$28 billion in 1981 to \$145 billion in 1986. The U.S. current account deficits had to be made up by borrowing from other nations. This required paying relatively high returns to the foreign lenders and investors, who then were willing to pay more to obtain dollars for investment in the U.S. The exchange value of the dollar continued to increase. The buyers of American products in foreign countries had to pay higher prices in their own currency, and the prices of foreign made products in the U.S. were lower in dollar terms. Trade and current account deficits kept growing.

It was recognized by the major industrial countries that they were all part of an international economy that had become more integrated, and that if trade imbalances caused an economic slowdown in one country, which then had to reduce imports, the others would also feel an adverse impact.

Beginning in 1983, there have been intermittent coordinated interventions in the international currency markets by Japan, Germany, and the U.S. to bring the U.S. dollar, the Japanese yen, and the West German mark into a better alignment to bring about a reduction of the U.S. trade and current account deficits. These efforts have led to decreases of over 40 percent since early 1983 in the value of the dollar relative to that of the German mark and the Japanese yen. Against currencies of other countries, however, the dollar decline has been only about 10 percent.

Despite the fact that the value of the dollar, against the mark and yen, had declined from February 1983 by more than 20 percent by the end of that year, and

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by about 40 percent by the end of 1986, the U.S. negative merchandise trade balance continued to grow. It totalled \$170 billion in 1986. The top 7 bilateral U.S. trade deficits for 1986 accounted for almost three-fourths of the total deficit. Measured in billions of dollars, they were as follows:

Japan	58.6
Canada	23.3
Taiwan	15.7
West Germany	15.6
South Korea	7.1
Italy	6.5
Hong Kong	6.4

Despite the substantial devaluation of the Japanese yen that was effective during 1985 and 1986, Japan still had, by far, the largest trade surplus with the U.S. in 1986; and it was a substantial increase over the previous year. Even though the rise in the value of the yen had raised the labor costs in Japan relative to those in the U.S., the comparative labor costs in manufacturing in Japan were still only 71 percent of those in the United States in the third quarter of 1986. The Japanese still had that margin toward offsetting shipping costs of products sold in the U.S. In addition, to counteract the effect of the devalued dollar, Japanese companies have been cutting their profit margins in order to maintain market share. And there has not been significant progress in the sale of American microchips and communications equipment in Japan, on which agreement was supposed to have been reached.

West Germany also had a measurable increase in its 1986 trade surplus with the U.S. as compared with 1985, but the absolute amount involved was smaller than Japan's gain. The increase was even smaller for Italy. Those three countries had significant appreciation in their currency relative to the value of the dollar during 1985 and 1986. Their hourly labor compensation costs in dollar terms had risen so

that by the third quarter of 1986 the costs in Germany were equal to those in the U.S.; but in Italy, they still equaled only 75 percent of the U.S. costs. The continuing labor cost advantage in Japan and Italy may have played a part in their continuing bilateral trade surplus with the U.S. There are also other factors, such as orders that had been placed before the full effect of the devaluation and profit margins that could be cut.

Thus far, however, there has not been a significant effect of the dollar devaluation toward improvement of the U.S. trade and current account balances. The latest monthly deficit trade balance figure for January was \$14.8 billion, or \$1.7 billion less than a year ago, but that largely reflected a decrease of \$2.2 billion in fuel trade, due to lower imported oil prices, which have since moved up.

The other 4 of the top 7 bilateral trade surplus countries for 1986 did not have any significant devaluation of their currency. They all reference their currency value to those of the U.S. dollar, even though they may not have a strict peg with the dollar. Canada had the second largest bilateral merchandise trade surplus with the U.S. at \$23.3 billion. Their comparative labor costs in manufacturing in the third quarter of 1986 were about 83 percent of those in the United States. Taiwan, with the third largest bilateral trade surplus, has a comparative labor cost of only 12 percent; South Korea, only 11 percent; Hong Kong, only 10 percent. Two other East Asian countries that also relate their currency to the dollar, but (in 1985) each had only about a \$1 billion trade surplus with the U.S., are Singapore and Malaysia. Singapore's labor costs in manufacturing in the third quarter of 1986 were 19 percent compared to the U.S. (We don't have it for Malaysia which shares a border with Singapore.)

Senator SARBANES. Thank you very much and I'm intrigued by the proposal in the last paragraph of your statement because I think that we have badly neglected in recent years a constant negotiating process on important economic questions.

I worked with Walter Heller for 1 year when he was Chairman of the Council of Economic Advisers in the Kennedy Administration and the emphasis that was placed on OECD and the OECD meetings and developing a concerted economic strategy on the part of the industrialized world and also as it dealt with the developing world was—I mean enormous stress was placed on that. Of course, that's not been done in recent years and we have this summit—we're about to have one in Venice, and it's a lot of theatrics but not a lot of solid work going on underneath all the time.

Mr. Fox, there's a section in the joint economic report that I'll just read to you that just parallels your point.

TRADE DEFICIT/TRADE IMBALANCE

We talk about the trade deficit and the need to redress the trade imbalance which if left uncorrected may lead to a recession, to do so through a policy framework that embraces world economic growth, currency revaluation, more open markets abroad, and trade policy reform at home.

Then it goes on to say, "Even assuming an export orientation is achieved, the problems of export expansion should not be underestimated. In 1986 merchandise imports were 60 percent larger than exports. So that exports would have to increase 60 percent faster than imports, simply to keep the trade balance from deteriorating, sustaining such differential growth rates for a prolonged period would be extremely difficult." I don't think people realize how deep we are into this box. In other words, if we can't—if exports don't grow 60 percent faster than imports, the trade balance will worsen.

Now asking them to grow 60 percent faster is a big assignment, but even if you achieve that, all you've done is leveled off your decline, and you haven't even started to come back out of the situation you were in.

I think your point on finding some way to focus attention on the exchange rate, so at least we don't go through a period like 1981 to 1985, where we are just absolutely taking it in the neck, without having that out in the open for public examination and discussion. And it seems to me that the House is—they are struggling with some way to institutionalize the process, and I am inclined to think that that's probably a good idea. You don't quarrel with that.

Mr. Fox. No, we favor that. I have some doubts about a requirement that the Treasury estimate what exchange rate would be a competitive exchange rate for the purpose of accomplishing the result, because there would have to be several exchange rates with different countries, and it also depends on the status in the business cycle. I think they would have to give a highly qualified answer. But the process of reviewing what should be the U.S. exchange rate objective and policy, I think is absolutely essential, because what we have now is what we have always had in this country. We concentrate on macro considerations of the budget deficit, the size of the fiscal deficit. We take a look at monetary policy,

reach certain targets, and the conclusion, perhaps, is accepted or takes place in the absence of acceptance.

And the exchange rate is the residuum. Now we all know the exchange rate in a very real sense responds to all kinds of factors, but most directly to monetary policy and the size of the budget deficit. If it is left to be a residual, what's the chances of our being able to get desirable monetary policy to achieve domestic objectives, in the face of a worsening international situation and one in which we are dependent on the in-flow of foreign capital?

So it seems to me that the circumstances require that in consideration of budget policy and monetary policy, explicit judgments be made with respect to the exchange rate. I think the House bill, although more specific than it might be, would require the expression of judgment by the Treasury with respect to the interaction of those three elements.

Senator SARBANES. And then maybe the situation won't deteriorate—this is the trade deficit. This is 1982 there [indicating], when it was about a \$40 billion figure, and this is where it's gone to [indicating]. And of course, the other side of that coin is this, which is the deterioration in the net asset position of the United States, which over the same period of time has gone from being the world's largest creditor nation of being the world's largest debtor nation, with, I think, very severe implications for the American standard of living in future years.

CURRENT ACCOUNT DEFICIT

Mr. Fox. Well, there is simply no question about that. The international indebtedness is sort of an arithmetic equation with the size of the current account deficit equal to the amount of the increase in over international debt. Most of the current account deficit is brought about by the trade deficit. We have now entered a new phase, where the current account deficit is made even larger because of Government borrowing abroad in support of the budget deficit.

Martin Feldstein has done a calculation, and I will just recite it and not try to explain it. But in view of the international indebtedness which has to be projected between $\$1\frac{1}{2}$ trillion and $\$3\frac{1}{4}$ trillion by the early 1990's, there will be a further deterioration in the growth of the U.S. standard of living. We will have a cheaper dollar, but also the terms of trade will turn against us even further, meaning, we will have to spend more for what we buy and get back less for what we sell. Under those conditions, he estimates that the real standard of living in the United States, as measured by real personal income—dealing with the inflation problem—will be reduced by one-fourth to one-half of the historical rate of growth.

The figure he uses is between 2 and $2\frac{1}{4}$ percent as being the historical rate of growth.

You knock off 25, 50 percent of that, we're all getting poorer in a relative sense. Now all the textbooks tell you, one of the advantages of the trade, is that it increases your standard of living. The United States has apparently managed to achieve the impossible situation, that trade will reduce our standard of living, and it is not

satisfactory in any way to have a strategy which is dependent on give backs from workers, so that our deterioration in our standard of living is borne even more heavily by workers, or may I say, former workers, in the manufacturing sector. It is really quite a disturbing prospect in the longer run.

Senator SARBANES. It certainly is. Mr. Schechter.

Mr. SCHECTER. We tend to speak about the U.S. position as a whole, including our competitiveness, forgetting, though, that it comes about because of individual companies' decisions. For example, the multinationals. We have had more and more closing of plants here to open up plants in Far East Asia. This benefits the particular firm in the short run, but what this causes is a redistribution of income you might say. Before we were in a market which was more closed, even 20 years ago. Our imports and exports involved only 7 percent of our GNP. Now they involve 14 percent. And we are in this larger market, which has a different income distribution than we had. And to the extent that production is transferred from our domestic economy to this larger global economy with the different distribution, and by the way, with a transfer of technology too, which goes along with it, so that the productivity can be there, but the distribution of the income produced is far different; and we are the big market where everybody wants to sell.

Now as our standard of living goes down, then the whole world loses that big market, and they—other economies—begin to deteriorate too, and even our multinationals or foreign countries that aim at this market will find themselves in trouble. I would hope that this sort of view could be made known more, and perhaps then we would get better international cooperation.

Senator SARBANES. Mr. Fox, I wanted to ask you whether the NAM has focused on this Third World debt problem that we have discussed, and in particular, whether you have a position that—I mean, I have this perception that our financial institutions, our manufacturing institutions are, in effect, at odds with one another, given the way we have tried to deal with the Third World debt problem, and that, in a sense, there's been a crowding out. The crowding out has been American workers and American producers, particularly in the manufacturing section.

DECLINE IN U.S. EXPORTS TO LATIN AMERICA

For instance, in Latin America, the figures on the decline in U.S. exports to Latin America in certain manufacturing sections are very, very dramatic; 1981 to 1984, iron and steel exports to Latin America fell 73 percent, construction equipment exports, 75 percent, agricultural machinery exports dropped 71 percent.

Mr. Fox. Senator Sarbanes, yes we have addressed that issue. As a matter of fact, NAM has a working group now on trade and economic relations with Latin America. We have chosen that area, because it is so important to our trade position, and we hope to issue a policy statement soon.

Our general view is that the debt situation has materially hurt American exports in an area where we traditionally had a very strong advantage. Geographical proximity is part of it, but also the historical relations. And when we talk about the nature of causa-

tion of the trade deficit, we always list the LDC debt problem, usually in the third category. The first being the exchange rate. The second, lack of economic growth abroad and the LDC debt, as the third issue.

Without trying to put too fine a point on how you make that distribution, I think that is quite accurate.

I would like to make a personal observation on the debt situation. This is not an NAM position as yet, but I am tempted to do by the conversation this morning.

If I see the situation correctly, all the efforts now turn on inducing the banks to continue to provide additional money to the LDC's to keep the thing going, whereas truthfully, the banks don't want to lend any more money to the LDC's. They would like to get out in whatever convenient form they can, and certainly, without jeopardizing their bank loans. And of course, it is not the wish of the banks to put it on the manufacturing sector of American economy to bear the cost, but to some extent that is the consequence, as the GAO statement indicates.

So to me, that means another source of finance is needed and the source of finance that I would suggest for consideration arises from the surpluses of Japan and Germany. There is a provision in the IMF, which requires adjustment to persistent surpluses. That provision has never been carried out. If you go back to Maynard Keynes' proposals for Bretton Woods—not too fashionable a source nowadays, but if you go back there, you will find the suggestion that persistent surplus countries ought to pay a surcharge on their IMF gold contribution—to the IMF, for its general lending. Now what Keynes had in mind was the dollar gap, which he thought would never disappear, and this surcharge would be paid by the United States.

It has an application now in quite a different way. Now my suggestion is not the Keynes idea at all, nor is it to invoke the surplus provisions of the IMF, because you just can't do it under present conditions.

My suggestion is that the German and Japanese governments be urged to put, as an investment in the IMF or the World Bank, a certain proportion of their surplus, not just from government-held reserves, but from private reserves, which could be obtained through a mechanism that I would describe in a minute, if you would like to pursue it.

Senator SARBANES. Well, I am going to have to interrupt you, because those five lights mean I am going to miss this vote on the highway bill, and I have got to go make that vote.

Let me simply say that I agree with that perception and, in fact, have written something about it.

Gentlemen, we are going to have to adjourn. We thank you very much for your testimony. It's been enormously helpful. We will stay in touch with you on these issues.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]

EXCHANGE RATES AND THIRD WORLD DEBT

TUESDAY, APRIL 7, 1987

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes, Proxmire, Dixon, Graham, Garn, Heinz, Hecht, and Gramm.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The subcommittee will come to order.

I am pleased to welcome Chairman Volcker here this morning to the seventh in a series of hearings which this Subcommittee on International Finance and Monetary Policy has been holding in preparation for the Banking Committee's consideration of legislation which will be pertinent and relevant to the trade bill that will be considered by the Senate in the next couple of months.

Over the past 4 weeks, the subcommittee has held hearings on export controls, the Export-Import Bank, export promotion, exchange rates, and international debt.

We look forward to hearing the testimony this morning of Chairman Volcker on his perspective on the dollar and exchange rates and the debt problem of Third World countries.

Mr. Chairman, we are pleased to have you with us this morning and look forward to hearing your testimony.

I don't know if my colleagues have a statement.

Senator DIXON. I have placed a statement in the record, with your leave, Mr. Chairman.

Senator HEINZ. I also would like to place a statement in the record.

[The complete statements of Senators Dixon and Heinz follow:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the subcommittee holds its fourth oversight hearing on Third World debt issues. I look forward to hearing the testimony of Chairman Paul Volcker of the Federal Reserve this morning.

I would once again like to suggest that the administration should renominate Chairman Volcker as Chairman of the Federal Reserve. I believe he has done an outstanding job as chairman and we

cannot afford to lose his valuable services during these difficult financial times. I certainly look forward to his testimony of Third World debt.

All those who have testified before this committee have agreed that this problem is formidable and potentially devastating to the world economy. In testimony before the full banking committee early this year, Chairman Volcker also indicated the enormous consequences the Third World debt crisis could have on the world economy.

A report done by the Federal Reserve last November on Third World debt expresses many of the concerns and possible consequences of the "Bradley plan" and other legislative initiatives in dealing with the debt issue. I am very interested in the Chairman's comprehensive opinion of the proposals by Senator Bradley, Secretary of the Treasury Baker and distinguished members of the House Banking Committee.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, we can all breathe a sigh of relief today as we complete a very challenging set of hearings in the International Finance Subcommittee. We have had 42 witnesses appear before us in less than a month—senior administration officials, noted academics, and U.S. businessmen covering every facet of international financial policy. And you have still managed to save the best for last. I want to welcome Paul Volcker to the subcommittee.

Chairman Volcker has the unenviable task of wrapping up our consideration of two of the most intractable problems facing the world economy—exchange rate realignment and management of the international debt problem. This is appropriate in light of the central role he has played in both issues.

The dollar was a concern 5 years ago as its strength surged and remains a concern as its value drops. While the direction is right, I don't think anyone believes we have gotten control of this problem. I look forward to the Chairman's insights on where the dollar is headed and prospects for meaningful G-7 policy coordination.

The discomfort level is even higher for the debt problem. The debt crisis that exploded nearly 5 years ago is now a permanent plague on the debtors, creditor banks, and the trade system. The Baker Plan provided an initial "breath of fresh air" but now seems more like "locked brakes." The sole focus is on new bank lending that the banks don't want to do. There is no innovation; no debt-equity swaps or measures to defer debt service are explored. To encourage the funds that never come, regulators treat bad loans on bank books as if they were stock in IBM. Only when a country bolts the door of the central bank do the regulators consider reserves or write-downs.

Our frustration is such that we are now considering public restructuring of private debt in a multilateral facility, or withdrawal from the problem behind a wall of reserves against LDC debt. I am convinced that we can yet breath life into the process while leaving

responsibility in the hands of the debtors and their creditors where it belongs.

I believe we must pursue a "carrot and stick" approach through regulatory action. Good performers and their creditors should be offered the incentive of supportive regulatory treatment for innovations that provide a break on debt service—debt-equity conversions, deferral of interest, and the like. Poor performers and their banks would face new bank capital requirements to protect against non-payment. Debtors and creditors must know that their recovery efforts have our support, but they must also know that lack of effort and failure have a high price.

Thank you, Mr. Chairman.

Senator SARBANES. Senator Gramm?

Senator GRAMM. No statement, Mr. Chairman.

Senator SARBANES. Mr. Chairman, if you would proceed.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, I will summarize parts of my statement anyway. You have asked me to address myself to the exchange market developments and international debt. Obviously, it's difficult to deal with those issues without considering the overall functioning of the world economy and problems of economic growth, balance-of-payments adjustment, and protectionism. These are very much intertwined today and we have to deal with all of them.

I do discuss a bit the degree of fluctuation that we've had in the exchange rates over this decade and indeed in the 1970's. I think it is troublesome that exchange rates have swung so widely and I discuss some of the problems in that connection. But in terms of the present situation, I don't think there's any doubt that a sizable realignment of currency values has been a necessary part of the process of restoring better balance to our trade and capital accounts and I believe the sustained economic growth and financial stability in the United States over the next few years is in fact importantly dependent upon improvements in our trade balance.

But I don't think we can be successful in that effort—namely, to improve the trade balance—if we fail to recognize the importance of factors other than exchange rate changes in redressing our trade balance. And I think there are clear dangers in relying too much on exchange rates alone.

The hard fact is that we have been spending more at home than we have been producing—about 3.5 percent more last year. The decline of the dollar provides incentives for more exports and for less imports, but if we are to improve our trade balance and to do so with a minimum of inflationary pressures, we will also have to slow the growth of spending at home, particularly for consumption, if we want to maintain investment. However, we will have to achieve a better balance between that investment and domestic savings if we are to be in a position to dispense with foreign capital.

BASICS FOR FUTURE GROWTH

In terms of laying the groundwork for future growth, progress in making these adjustments seems to me more important than achieving a particular rate of overall economic growth this year.

The constructive way to work in the needed direction would be to reduce our budget deficit year by year, paving the way for improvements in our trade accounts.

In contrast, looking toward depreciation of the dollar alone to improve our trade balance would clearly pose substantial risks of renewed inflationary momentum and undermine confidence in future financial stability—developments that could jeopardize prospects for a sustained economic expansion.

I think you are well aware that some warning signs of just such developments have appeared in recent weeks.

I don't know of any reliable way of judging now whether several years ahead the dollar vis-a-vis other currencies will ultimately need to be higher or lower consistent with the restoration of a sustainable trade position. Too much in that connection depends upon other important factors and policies affecting relative growth and competitive performance here and abroad.

What we do know is that a substantial exchange rate adjustment has already been made. That adjustment should be large enough in the context of a growing world economy and fiscal restraint in the United States to support the widespread expectations of a narrowing in the real trade deficit in the period ahead.

There are indications that the volume of our exports is now growing and growing substantially, and some slowdown in the growth or even a decline in the volume of imports seems possible this year.

In real terms, the deficit in our trade narrowed in the fourth quarter of last year.

Whether and how soon improvement in the real trade balance this year will be accompanied by a reduced trade deficit in dollar terms—the kind of data you see published each month—is more problematical. The trouble is, higher dollar prices of imports as the dollar depreciates, the well-known J-curve effect might offset improvement in the volume of net exports for some time. That phenomenon itself points to one of the dangers of looking to depreciation of the dollar alone to deal with the trade problem. It generates inflationary pressure and could actually prolong J-curve effects, perhaps raising more doubts about our ability to finance our current account deficit.

I discuss the importance also, Mr. Chairman, of strong markets abroad if we are indeed to improve our trade balance and I express some concern about the tendency for growth to slow. Domestic expansion in the major surplus countries has not been very vigorous recently and in that kind of a situation further sizable depreciation of the dollar could well be counterproductive.

The fact is, it will take time and other policy changes both here and abroad to achieve the shift in resources necessary to achieve better international balance. Excessive volatility in exchange rates could jeopardize instead of speed the process by impairing prospects for investment and growth in the surplus countries.

Now all of that I believe is the sense of the understandings reached among the leading industrial countries in Paris in February, looking toward greater stability of exchange rates around current levels. Those understandings have been reflected in active intervention in exchange markets in recent weeks but intervention taken alone is, of course, a limited tool. Confidence in the current exchange rate levels will in the end depend upon perceptions that more fundamental policies than intervention will in fact be brought to bear.

I have emphasized the need for complementary changes in fiscal policies in the United States, Germany, and Japan. The conduct of monetary policy here and abroad will be relevant as well. The performance of the dollar in the exchange market might become a factor bearing on our provision of reserves and I should think our central bank colleagues abroad may wish to take account of such circumstances as well.

We certainly do need some improvement in our trade balance, Mr. Chairman. I think there are some encouraging signs, but there are practical limits on how fast we can go. What it seems to me we need now, instead of more depreciation, is action to carry through on the other measures needed to support growth and adjustment, specifically action to reduce the budget deficit here and to provide stimulus abroad.

We need for those actions and the earlier depreciation to work their effects and we need the patience to see it through without embarking on self-destructive protectionist policies.

INTERNATIONAL DEBT

My statement then turns to the international debt situation and I note that there is clearly a danger that adequate financing arrangements are not being negotiated and put in place in a timely way. Borrowing countries that have demonstrated their intent and ability to carry out effective economic programs need to be able to proceed with confidence that necessary funds will in fact be available to support those programs.

More broadly, sluggish growth in the industrialized world that I discussed earlier has affected the export markets of the heavily indebted countries, slowing their return to full economic and financial health.

So I think there are very real problems in this area but I also believe that in discussing these problems there has perhaps been too little appreciation of how much progress the heavily indebted countries themselves have made toward laying the groundwork for renewed and more sustainable growth and I try to describe that progress in several pages in my statement, Mr. Chairman. They have made remarkable progress in reducing their current account deficits and reducing their budget deficits and bringing their exchange rates into a better competitive position and, in a way, the most heartening improvements have been made in certain structural changes in their economy moving toward I think it's fair to say, a more liberal economic order, tending to reduce—in fits and starts, perhaps unevenly, but nonetheless, tending to reduce the degree of state control on their economies and giving a little more

Given those comparative labor costs, even if the newly industrialized Asian countries had allowed the U.S. dollar devaluation to take place without revaluing their own currencies, in other words, if the labor costs advantage of 80 percent or 90 percent over the U.S. had been reduced by 40 percent, they would still have a very significant advantage in labor costs. In addition, some of them have large new, very modern plants, such as Korea's large steel plant, which was built with the aid of a good deal of government capital, or new plants that have been established in those countries by U.S. multinationals. Incidentally, the Japan Development Bank also provides government capital to participate in new industrial ventures. Even if the newly industrialized countries of East Asia could be pressured into letting their currencies float upward against the U.S. dollar to the extent that it was devalued, it would require even greater U.S. devaluations to begin to place those countries on a relatively level playing field. We know, however, that Japan and to some extent Germany are already dug in against any other further dollar devaluation because it would put their producers at a greater international price disadvantage. That would have an even greater adverse impact upon their economies than has been established by the dollar devaluation that has taken place thus far. And they have been reluctant to see further U.S. currency devaluation which makes it harder for them to sell abroad and subjects them to increased unemployment.

The economic balance between production capacity and consumer demand, that sustained a growing market in the U.S., does not prevail in the global economy the way it has been reshaped. In that connection, it should be noted that voluminous indebted developing countries, such as those in Latin America, have been forced to devalue their currencies in order to export more so as to have a

positive current account balance large enough to meet debt service payments. However, their currency devaluation also reduced their workers' incomes and demands for U.S. products. The U.S. economy and its workers are being affected adversely. Continued penetration of the U.S. market by foreign producers creates increased U.S. joblessness and the lowering of wage scales, which contracts the largest market in the global economy.

Before too long, because of the lower levels of wages and economic imbalances, the producers in other countries mentioned will have to sell in U.S. and world markets that are less affluent than when workers producing the products received a better share of the sales value of the product. Sales volume, benefits of economies of scale, and profits for developing country producers will be reduced. These facts of the situation have precluded sustained high level economic growth of the United States, which a few years ago had been pictured as the locomotive for worldwide economic growth that would enable the debtor nations to enjoy growth and to pay their debts.

In a number of the low-wage countries, there is suppression of the rights of workers to organize and to engage in collective bargaining, exacerbating the economic imbalances and slowing growth in the international economy. U.S. legislation is needed to define as an unjustifiable act, the failure on the part of a country to take steps to adopt internationally recognized worker rights, as contained in Title V of the Trade Agreements Act of 1984. Failure to take such steps should result in the denial of most-favored-nation treatment as long as that country remained out of compliance. The AFL-CIO strongly believes that competitive advantage in trade should not be derived from the denial of the right to freedom of association, the refusal to insure a safe work environment, the absence of

acceptable standards for minimum wages, the exploitation of child labor or other such reprehensible practices. It should be emphasized that the inclusion of these worker rights and standards in U.S. trade law does not require the international adoption of U.S. practices. There already exists international agreement on their meaning through the conventions of the International Labor Organization. For example, acceptable standards for minimum wages does not mean the adoption of the U.S. minimum wage, but the establishment of minimum wage machinery commensurate with a country's level of development.

Exchange rates of various countries cannot be considered in isolation. To deal with all of the interrelated international monetary, trade, debt, and labor relations matters, instead of relying on the pageantry of an annual economic summit of the big seven, and a few special finance minister conferences during the year, there is need for a continuous combined, simultaneous negotiation on all of these subjects to be carried on by high level, technically competent staff representatives from the countries involved. The U.S. staff representatives should be led by a Special Ambassador for International Economic Negotiations who would report back to the President frequently for instructions; and the latter would, of course, have to approve any agreements. This would resemble the disarmament negotiations with Russia, but hopefully would prove more fruitful. While economic peace may not be quite as critical as military peace, it is important enough to merit continuous negotiation.

room to the entrepreneurial spirit and I think that that is all promising.

On the other hand, by and large, they have squeezed investment in a way that hurts their future prospects for growth which points up the need for making financing available.

The World Bank has certainly stepped up its efforts in that connection in the past year or two and I think it's more or less on track in terms of the broad concepts set out in the so-called Baker plan. Their disbursements increased by about 40 percent last year from the rate of earlier years and that has been in support of important changes in various sectors of the borrowing countries' economies or their structure which are designed to move in a constructive direction to support growth in the future.

There's been a good deal of restructuring of debt by both governmental and private lenders and interest rates on many bank credits have been negotiated downward. Of course, the level of world interest rates has declined and, as a consequence, the burden of external interest payments has been falling, despite some increases in debt.

I also note that if you look at it from the other side of the equation, from the standpoint of commercial banks, exposure to the heavily indebted countries relative to their own capital has declined sharply. For all American banks, the ratios of such loans to capital have now declined by close to 50 percent since the debt crisis broke and I think foreign banks have probably had a bigger decline in relative exposure because many of these loans are denominated in dollars and their own capital is denominated in appreciating currencies.

All of that progress is welcome, but I still think we have problems in making sure the heavily indebted countries that are doing a good job can count on receiving in a timely way those funds that are necessary to support well conceived economic programs and to support necessary levels of domestic investment.

In that connection, I must report that the amount of net new bank lending virtually stopped apparently in 1985 and 1986. I think it's fair to say that there have been differences in viewpoint and emphasis among banks that have slowed the process. Those with large exposures as against those with limited exposures, banks in one country as against those in others, banks with continuing interest in international lending as against those that want to withdraw—those competing interests are difficult to work out. The differences are natural, but what is disturbing is that in fact it's been more difficult to arrive at a consensus and to implement the consensus about new lending or restructured loans.

There has not been the same sense of urgency and willingness to cooperate in the larger general interest that was evident in 1982 and 1983. Of course, the irony is that if there is a failure to arrive expeditiously at mutually satisfactory financing agreements, there will again be a great threat to the success of the overall effort. Moreover, doubts about financing undermine the resolve of the borrowing countries to carry out needed economic reform.

So I don't think an environment of successive financing crises is at all in the interest of the banking community itself, as well as the world generally.

NEW FINANCING ARRANGEMENTS

Fortunately, in recent weeks, I think we can see a sense of renewed effort and commitment emerging once again, and there are a list of countries that have reached agreement on new financing arrangements in recent weeks. There are initiatives underway among the banks themselves to sort out their competing approaches and I hope arrive at a better consensus for future lending operations.

That is all currently being tested in an important test—the case of Argentina that does need both restructuring of old debts and some new money to support their economic programs over the next year or two.

As you are well aware, Brazil presents a very large special case. The biggest borrowing country of all is in a very difficult position. I want to say in that connection that Brazil has an enormous potential. Given its human and material resources, I think it has the potential for becoming one of the world's leading economic powers and it has demonstrated over and over again as recently as last year its competitive strength and vitality and adaptability.

But at the same time, as for any country, realization of that very large potential over an extended period is dependent upon consistent and effective economic policies at home and on strong and harmonious trade and financial relationships with other countries.

As a practical matter, the necessary regularization of external payments by Brazil is going to take a concerted effort and some time. I think the key prerequisite is clearly in the hands of the Brazilian authorities. They have to shape an economic program that commands the support and confidence of Brazilians first of all, and then the world community. And on that base, I think both Brazil and its creditors, official and private, have the strongest kind of incentive to work together to develop external financing arrangements consistent with strong and sustained growth.

Now that is a special instance, a very important instance of the challenge that we face throughout Latin America and with the other highly indebted countries.

I would emphasize in closing, again, that the success of that effort as well as the success in dealing with our own trade balance, does depend upon both growth and open markets in the industrialized world and that responsibility obviously lies with the United States and with our principal trading partners.

Thank you very much, Mr. Chairman.

[The complete statement of Paul Volcker follows:]

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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on International Finance and Monetary Policy

Committee on Banking, Housing, and Urban Affairs

United States Senate

April 7, 1987

I welcome the opportunity to appear before you today to review some aspects of the world economic situation. In particular, you asked me to concentrate on exchange market developments and international debt. These issues are in turn related to the overall functioning of the world economy. Indeed, I would argue that the problems of economic growth, balance of payments adjustment, protectionism, and international debt are so intertwined today that a failure to deal constructively with any one of them would risk failure across the board.

Instability in Exchange Rates

So far in this decade we have experienced tremendous swings in the value of the dollar. Measured in terms of a multilateral-trade-weighted average against the currencies of the other G-10 countries, the dollar's value rose about 80 percent from 1980 to the first quarter of 1985. It has since retraced most of that rise and is now at a level only about 10 percent above its average in 1980 when our current account was close to balance.

Large swings in exchange rates among industrialized countries over periods of several years were also characteristic of most of the 1970s. However, if anything, the fluctuations have appeared to become greater, rather than less, as the period of floating rates has been extended.

In themselves, such wide swings in exchange rates are troublesome. When exchange rates among nations fluctuate much more widely than relative changes in domestic prices, productivity and other basic economic variables, economic units producing internationally tradeable goods receive misleading price "signals" over time. Investment decisions may be distorted, and individual firms and workers can be whipsawed by fluctuations in price competitiveness internationally. For the economy generally, deflationary or inflationary impulses may complicate the task of economic management and affect the stability of financial markets.

However, it does little good merely to rail against excessive fluctuations in exchange rates without being prepared

to do something about them. And that "something," in the end, involves appropriate national economic policies and reasonable consistency and complementarity among the policies and performance of major nations. In fact, national policies during much of the 1980s have, in important respects, diverged in ways that put pressure on exchange rates and distorted trade positions, even though inflation rates have tended to converge at much lower levels.

For one thing, the U.S. federal budget deficit was high and rising as budget deficits in other countries were being reduced. For several years, growth in the United States was substantially stronger than elsewhere and our interest rates were relatively high. Although U.S. growth overall has since slackened, expanded consumption has depressed further our chronically low personal savings rate.

As a result, there have been strong incentives for a flow of capital from abroad into the United States. For a time,

that flow pushed up the dollar, and that strength was probably amplified by more speculative forces. The result of the strong dollar and our relatively rapid growth in domestic demand was a sharp deterioration in our international competitive position and in our trade and current accounts.

The rising trade deficit, lower interest rates, and slower growth have all worked in the direction of reducing dollar exchange rates over the past two years. Relative to the Japanese yen and the German mark, the dollar is at, or close to, all time lows.

No doubt a sizable realignment of currency values has been a necessary part of the process of restoring better balance to our trade and current accounts. Moreover, I believe sustained economic growth and financial stability in the United States over the next few years is importantly dependent on improvements in our trade balance. But I do not believe we can be successful in that effort if we fail to recognize the importance of factors other than exchange rates in redressing

our trade balance. There are clear dangers in relying too much on exchange rates alone.

The hard fact is that we have been spending more at home than we have been producing -- about 3-1/2 per cent more last year. The decline in the dollar has provided incentives for more exports and for less imports. But if we are to improve our trade balance, and do so with a minimum of inflationary pressures, we will also have to slow the growth of spending at home, particularly for consumption. We want to maintain investment. However, we will have to achieve a better balance between that investment and domestic savings if we are to be in a position to dispense with foreign capital. In terms of laying the groundwork for future growth, progress in making these adjustments seems to me more important than achieving a particular rate of growth overall this year.

The constructive way to work in the needed direction would be to reduce our budget deficit, year by year, paving the way for improvements in our trade accounts. In contrast,

looking toward depreciation of the dollar alone to improve our trade balance would clearly pose substantial risks -- renewed inflationary momentum and undermine confidence in future financial stability -- developments that could jeopardize prospects for sustained economic expansion. You are well aware that some warning signs of just such developments have appeared in recent weeks.

I know of no reliable way of judging now whether several years ahead the dollar vis-a-vis other currencies will ultimately need to be higher or lower, consistent with restoration of a sustainable trade position. Too much depends upon other important factors and policies affecting relative growth and competitive performance here and abroad. What we do know is that a substantial exchange rate adjustment has already been made. That adjustment should be large enough, in a context of a growing world economy and fiscal restraint in the United States, to support the widespread expectations of a narrowing in the real trade deficit in the period ahead. There

are indications that the volume of our exports is now growing substantially, and some slowdown in the growth, or even a decline, in the volume of imports seems possible this year. In real terms, the deficit in our trade narrowed in the fourth quarter of last year.

Whether and how soon improvement in the real trade balance this year will be accompanied by a reduced trade deficit in dollar terms -- the data published each month -- is more problematical. The trouble is higher dollar prices of imports as the dollar depreciates -- the well-known J-curve effect -- might offset improvement in the volume of net exports for some time. That phenomenon itself points to one of the dangers of looking to depreciation of the dollar alone to deal with the trade problem: it generates inflationary pressures and could actually prolong "J-curve" effects, perhaps, raising more doubts about our ability to finance our current account deficit.

Prospects for achieving solid and steady improvement in our external trade -- and doing so in a context of sustained

world growth -- is critically dependent upon the strength of markets abroad, and on whether they are open to us. Unfortunately, the evidence on that score is not entirely favorable.

Specifically, growth of real GNP in foreign G-10 countries on average slowed to about 2-1/4 percent last year (fourth quarter to fourth quarter), almost 1/2 percent less than in 1985. To be sure, much of that slowdown reflected reduced export growth rather than reduced domestic demand. But clearly, domestic expansion in those countries was not enough to offset the effects of the trade adjustment. And the clear danger now in most other industrialized countries is that growth may be slowing further.

In that kind of situation, further sizable depreciation of the dollar could well be counterproductive. It will take time and other policy changes both here and abroad to achieve the shift in resources necessary to achieve better international balance. Excessive volatility in exchange rates could jeopardize instead of speed the process by further impairing prospects for investment and growth in the surplus countries.

That I believe is the sense of the understandings reached among the leading industrial countries in Paris in February looking toward greater stability of exchange rates around current levels. Those understandings have been reflected in active intervention in the exchange markets in recent weeks. But intervention, taken alone, is of course a limited tool.

Confidence in the current exchange rate levels will in the end depend upon perceptions that more fundamental policies than intervention will in fact be brought to bear. I have emphasized the need for complementary changes in fiscal policies in the United States, Germany, and Japan. The conduct of monetary policy, here and abroad, will be relevant as well. The performance of the dollar in the exchange market might become a factor bearing on our provision of reserves; I should think our central banking colleagues abroad may wish to take account of such circumstances as well.

In sum, we plainly do want and need improvement in our trade balance. There are some encouraging signs in

that respect. But there are also practical limits as to how fast the necessary massive shift in resources can be accomplished if the momentum of world expansion is to be maintained. Undercutting investment and growth abroad at a time when growth prospects are already relatively weak is neither in their interest nor ours. Undercutting our own prospects for price and financial stability by a weak dollar is equally unattractive.

What we need now, instead of more depreciation, is action here and abroad to carry through on those other measures needed to support growth and adjustment -- specifically action to reduce the budget deficit here, and to provide stimulus abroad. We need time for those actions, and the earlier depreciation, to work their effects. And we need the patience to see it through, without embarking on self-destructive protectionist policies.

The World Debt Situation -- Progress and Problems

Patience is difficult enough for rich countries like the United States; for the heavily indebted countries of the developing world, the plea wears thin without supportable prospects for greater economic growth and stability. In that connection, I do not share the sense of some that radical new approaches to the debt problem are necessary or practicable -- indeed, writing down and forgiving debts that can reasonably be serviced would risk undermining growth and stability in the borrowing countries. But I also believe that we would be blind to fail to recognize shortcomings in implementing present approaches.

Specifically, there is clearly a danger that adequate financing arrangements are not being negotiated and put in place in a timely way. Borrowing countries that have demonstrated their intent and ability to carry out effective economic programs need to be able to proceed with confidence that necessary funds will in fact be available to support those programs.

More broadly, sluggish growth in the industrialized world has affected the export markets of the heavily indebted countries, slowing their return to full economic and financial health. For awhile, in 1983 and 1984, as the United States led world recovery, markets of the borrowing countries expanded at a rapid pace. Then the growth rate for industrialized countries dropped to 3 percent in 1985 and to less than 2-1/2 percent last year. As things stand, prospects are no better -- and perhaps worse -- in 1987. Taking the whole period since 1982, Europe and Japan have increased their imports very little from Latin America. Plainly, it is in our collective interest, as well as that of the indebted countries, to do better.

Meanwhile, my sense is that there has been too little appreciation of how much progress the heavily indebted countries themselves have made toward laying the groundwork for renewed and more sustainable growth. To take one key measure of adjustment, the combined current account deficit of the so-called Baker-15 countries declined from the \$50 billion range in 1981-82

to essentially zero in 1984-85. The aggregate deficit widened again by about \$10 billion in 1986, but that almost entirely reflected the decline in oil and other commodity prices. Even under those circumstances, the deficits have collectively been within the amounts envisaged when Secretary Baker outlined the "Program for Sustained Growth" in Korea in 1985. At the same time, capital flight in most borrowing countries has tended to slow; it has even reversed in some.

Reflecting those factors, growth in the external debt of the most heavily indebted countries has slowed sharply, averaging less than 3-1/2 percent a year in dollar terms since 1982. With reasonable rates of economic expansion both in the borrowing countries and in the world at large, that rate of increase in external debt should be manageable and consistent both with declining debt burdens for borrowers relative to GDP or exports and with reduced exposures of lenders relative to their capital and assets.

I realize neither world growth nor growth by borrowing countries has recovered to "pre-crisis" levels. Nonetheless, along with the progress in external adjustment, many of the major borrowing countries have also experienced significant recovery in economic activity. A few -- Brazil, Chile, Colombia, and Morocco -- have achieved a substantial pickup in economic growth, averaging more than 4 percent per year during the past three years. For the 15 heavily indebted countries as a group, real GNP has grown by some 8.8 percent since 1983.

Measured against the performance of the 1970s, when foreign finance was so freely available, or against prospective needs, the improvement in economic activity, employment, and living standards has not been satisfactory. But a full measure of success by those criteria was hardly possible in so short a period of time. Plainly, the earlier amounts of lending from

abroad are simply not available today. Instead, some fundamental economic adjustments have been required to build a more solid foundation for sustained growth.

Naturally, the degree of success in making those adjustments has varied from country to country. In difficult economic and political circumstances, punctuated by natural disasters and external shocks, some setbacks have been inevitable. But what is so striking overall is the amount of progress that has been achieved.

In country after country, fiscal deficits are under better control than at the beginning of the decade. Chronically overvalued exchange rates have been brought into more realistic competitive alignments, enabling their industries to compete more effectively in world markets. At the same time, the exchange rate and fiscal changes have helped create conditions in which the borrowing countries could be more open to international competition --

quantitative import restrictions, licensing requirements, and tariffs have, on balance, been reduced. Other efforts are underway to limit the role of the state in the economic system by cutting back on subsidies, credit allocation, and in some instances public ownership of industry.

One area that has been squeezed that reflects adversely on future prospects is investment. That points up the need for some margin of fresh funds from abroad to support growth. The provision of such funds from both public and private sources has been, of course, one of the basic elements of the "Baker Plan."

Both the IMF and the World Bank have played important roles in that respect. In particular, the World Bank over the past year, complementing the efforts of the Fund, has embarked on an ambitious program to define and to support financially structural changes that would provide a basis for debtor countries to resume more vigorous economic growth. This has entailed an intensive process of consultation with each of the

largest indebted countries to develop policy approaches that are both strategically important for improving economic efficiency and politically feasible.

During the past two years, the most significant structural changes adopted by the major indebted countries have been in the area of trade policy. Nigeria, Mexico, Chile, Colombia, and Ecuador have each taken steps to liberalize their import restrictions -- and at the same time, have been able to achieve impressive growth rates for their non-traditional exports. In other instances, huge credit subsidies to agriculture or other sectors have been reduced while other measures have been taken to enhance the efficiency of those sectors.

Overall, disbursements by the World Bank and the regional development banks to the "Baker 15" increased to \$7-1/2 billion in 1986, almost 40 percent above the rate of 1983-85. Disbursements should increase further this year to the levels envisaged by the "Baker Plan." These institutions

will certainly provide a substantially larger proportion of new funds flowing to Mexico and other heavily indebted countries than in earlier years.

Both governmental and private lenders have restructured outstanding debts of the borrowers, and interest rates on many bank credits have been negotiated downward. More importantly, world interest rates have declined in both nominal and real terms. As a result, the burden of external interest payments has been falling despite some increases in debt.

From the perspective of the commercial bank lenders, progress has been more striking. Exposure to the heavily indebted countries relative to their capital bases has declined sharply. For all U.S. banks, the ratios of such loans to capital have by now declined by close to 50 percent. Relative exposure of foreign banks has probably declined even more since 1982, as a result of the depreciation of the dollar.

That progress is welcome in terms of the implications of reduced financial pressure on lenders and borrowers alike.

However, there is another side to the coin. The heavily indebted countries need to be able to count on receiving in a timely way those funds reasonably necessary to support well-conceived economic programs -- and in particular necessary levels of domestic investment. Available data suggest net new commercial bank lending virtually ceased in 1985 and 1986, and certainly was below amounts assumed in the approach outlined by Secretary Baker.

Part of the difficulty has been the length of time required to negotiate and syndicate the large new Mexican loan -- the gestation period is now approaching nine months. Underlying the delay in that instance and others has been evident differences in viewpoint and emphasis among banks -- those with large exposures as against those with limited exposures, those in one country as against those in others, those with continuing interests in international lending and those who want to withdraw.

While differences in approach and priority are natural, and have been present from the start, what is disturbing to many bankers and borrowers alike is the increasing difficulty in arriving at a consensus, and once reached, implementing that consensus effectively and speedily. What has been lacking is the sense of urgency and willingness to cooperate in the larger general interest that was so evident in 1982 and 1983. The irony is that it is precisely a failure to arrive more expeditiously at mutually satisfactory financing agreements that may be the greatest threat to the success of the overall effort. In some instances, doubts about financing undermine the resolve to carry out needed economic reforms. And an environment of successive financing crises can hardly be in the interests of the banking community itself.

Fortunately, a sense of renewed effort and commitment seems to be emerging. Restructuring agreements were recently completed with Venezuela and the Philippines and financing arrangements with Chile modified, in each case, after months of discussions.

Initiatives are underway among U.S. regional banks, looking toward the development of innovative approaches to broaden the choices of banks in structuring their participation in new financing programs. Discussions among banks at an international level should help deal with points of friction.

In all these discussions, the issue of "free riders" will need to be dealt with effectively: the cohesion of the entire effort will be undermined to the extent some creditors "opt out" of participation in new credits or restructurings while continuing to receive interest and principal payments.

The success of all this renewed effort is being tested in important negotiations with Argentina. That country is among those making substantial progress in recent years toward greater domestic stability and restoring growth, despite its heavy dependence on severely depressed world grain markets. Argentina has been working closely with the IMF for several years, and the World Bank is prepared to provide additional financing to

support sectoral reforms. But it is also clear that restructuring of outstanding loans and some margin of new credit will be necessary to support growth and to maintain continuity in debt service. Early agreement on those matters seems to me obviously in the interests of Argentina and lenders alike, providing a base for greater confidence that their objectives -- some common and some different -- can be reached.

The largest developing country debtor -- Brazil -- is obviously in a difficult position today. After a period of strong domestic growth and large trade surpluses, strong inflationary forces again developed, the external position deteriorated, and the momentum of expansion has been interrupted. In the circumstances, with international reserves rapidly falling, the government suspended servicing medium and longer-term bank debt.

Given its enormous human and material resources, Brazil clearly has the potential for becoming one of the world's leading economic powers: its competitive strength, vitality, and adaptability

have been demonstrated again and again in recent years. At the same time, as for any country, realization of that potential over an extended period will clearly be dependent upon both consistent and effective economic policies at home and strong and harmonious trade and financial relationships with other countries.

As a practical matter, the necessary regularization of external payments by Brazil will take concerted effort. The key prerequisite is clearly in the hands of Brazilian authorities -- shaping an economic program that commands the support and confidence of Brazilians themselves and the world community. Given that base, both Brazil and its creditors, official and private, seem to me to have the strongest kind of incentive to work together to develop external financing arrangements consistent with strong and sustained growth.

Conclusion

In more general terms, that is of course the challenge for all the heavily indebted countries and their creditors.

It seems to me a challenge that will continue best to be approached case-by-case, taking account of the different circumstances and problems of each country. But there are, of course, common needs that run through all the particulars.

First, a successful approach needs to be premised on the requirements for growth. That is not simply a matter of providing external financing, critical as that may be at the margin. It is first of all a matter of the intelligent design of effective domestic programs.

Second, sustained economic growth, and the growing imports and exports that are an indispensable part of that process, is importantly dependent on access to world financial markets. Continuity in debt service and negotiated settlements are critically important in maintaining those relationships.

Finally, success in the common effort will depend upon growing and open markets in the industrialized world. That

responsibility plainly lies mainly with the United States and its principal trading partners.

It is an effort that, in my judgment, needs to be reinforced by appropriate fiscal and other policies here and abroad. It is an effort that would be placed at risk by excessive instability in exchange rates. And it is an effort that would be undermined entirely by a retreat into protectionism.

I trust that we will have the collective will and wisdom to take those steps that are necessary and to reject those that could only be counterproductive. Too much is at stake to do otherwise.

Senator SARBANES. Thank you very much, Chairman Volcker. I think we will take a 10-minute round, given the number that are here.

Mr. Chairman, I wanted to address myself to pages 8 and 9 of your testimony. Accepting the proposition that changes in exchange rates alone cannot remedy the trade balance—and you are very careful to use that phrase throughout, which I take it to mean that changes in exchange rates at least to some extent are relevant and important.

Mr. VOLCKER. Well, I think it was inevitable and necessary that we had a major realignment in the past couple of years.

STABILIZING EXCHANGE RATES

Senator SARBANES. Now apparently there's an effort to stabilize the exchange rates, as you indicate in the first paragraph of page 9. At the same time, we do not have the growth in these industrial surplus countries that we want. The growth is all prospective. The stabilizing of the exchange rates takes place right now.

Now to the extent that you're in that sequence of events, it seems to me that we're confronting a situation in which the trade balance will not improve. It will worsen, will it not? If part of the deal is to have growth in return for stabilizing the exchange rates, and the growth is 1 year, or 18 months, or 2 years down the road, and the stabilizing of the exchange rates is right now, it seems to me you're not getting the supposed results of the deal.

Mr. VOLCKER. Well, I think what you are leaving out of the equation, if I may suggest, Mr. Chairman, is the fact that the exchange rate has depreciated a great deal over the past couple of years and that takes time to become effective. And when one looks forward into 1987 and 1988 we will be experiencing the effects of that very large depreciation we have already had.

And I would like to have that chance to work itself out without further disturbance in the exchange markets or possible disturbances in domestic financial markets that would follow in the wake of continuing depreciation.

Senator SARBANES. Well, now you indicate that the clear danger now in most other industrialized countries is that growth may be slowing even further.

Mr. VOLCKER. Right.

Senator SARBANES. Now if growth slows even further but exchange rates stabilize, where does that leave us in trying to work out the kind of arrangement which I take it was part of the Paris deal?

Mr. VOLCKER. Well, I think where it leaves us is with a continuing emphasis on the need for measures to be taken, if they are necessary, to stimulate growth and provide some impetus abroad.

My problem in part is that a change in exchange rates—or at least a depreciation of the dollar—a further sizable depreciation of the dollar might in fact be counter-productive in that effort.

One of the reasons you are getting slower growth in those countries is because of I suppose the past exchange rate changes. They are going to have to grow more slowly externally, and that's part of the effort—to remove the stimulus that they have had from a

growing trade surplus, to move toward a smaller trade surplus. That damages their growth. They have to have some offsetting domestic growth.

What you don't like to see is so much pressure on the external side that it feeds back into the domestic economy, including domestic investment in those countries, so that you don't get the growth and that is precisely the concern that you're suggesting—if you don't get the growth, it's not going to help us restore balance in our position.

Senator SARBANES. Do you think the exchange rates have properly aligned themselves with regard to some of the Pacific Rim countries, in particular, those that have tied their currency to the dollar?

Mr. VOLCKER. Well, I think some of those countries—take Taiwan in particular—have an enormous surplus. They have a large amount of reserves and, relative to the size of the country, it is running a very large surplus, which indicates certainly that they are out of balance, out of equilibrium on the surplus side. So it strongly points toward measures, whether they're exchange rate measures or other measures, to restore better balance to their external position. They are very restrictive in terms of import policy, and liberalization of imports could be a very constructive contribution.

But Taiwan sort of stands out alone in terms of the magnitude of that problem.

Senator SARBANES. What are the other measures you would suggest? Exchange rate adjustments. What else?

Mr. VOLCKER. Well, for those particular countries?

Senator SARBANES. Yes.

Mr. VOLCKER. It's a question of domestic growth too, but I think perhaps the main emphasis ought to be on import liberalization.

Senator SARBANES. You talked in the first part of your statement about the fluctuation of the exchange rates, the instability, and said in themselves such wide swings in exchange rates are troublesome and then went on to develop that point.

Do you think we have reached a point where we need to seriously address new structural arrangements with respect to exchange rates?

Mr. VOLCKER. Well, I certainly indicate some restiveness over what's been happening over the past 15 years anyway, which points in the direction that you are suggesting. But I don't have any particular proposals to put on the table in that connection and I don't want to suggest that I think it is an easy job that can be accomplished very quickly. I don't think we are ready for an international monetary conference kind of thing, but I do think we ought to be thinking about and working toward greater stability in the exchange rates.

I think the objective of greater stability in the exchange rates ought to loom larger among our various policy priorities.

POSSIBILITIES FOR STABILIZING EXCHANGE RATES

Senator SARBANES. Well, without committing anyone to a particular approach for achieving that, what are some of the possibili-

ties we should be thinking about in terms of achieving greater stability in exchange rates?

Mr. VOLCKER. Well, in the most general sense, I think it does involve questions of monetary and fiscal policy and the mix of monetary and fiscal policy for the United States and for our leading trading partners. I think you're essentially dealing here with a problem between the major European currencies, the yen, and the dollar. That is the core of the problem.

And the only way you're going to be successful in getting more stability in exchange rates is if the blend of domestic policies among those countries is oriented to some degree toward stability in the exchange rates. The rest of it is details and very important details. But conceptually, you can't avoid coming back to those questions of the orientation of the basic economic policy measures that we have at our command.

Now whether that can be done, as I suppose one would describe the present system, through a process of informal consultation of which there is quite a lot, or whether it requires more mechanical—if that's the right word—elements in the international monetary system to provide more precise rules of the game, more precise guideposts and incentives, I think that is the question of international monetary reform—the degree to which you have to move in that direction.

We have a very loose system at present, as you know. It does rely upon essentially a series of ad hoc consultations. There are discussions, there have been discussions. Progress is pretty slow internationally as to whether greater discipline could be put into that process to giving more weight to objective indicators. You set out some targets in effect for growth, for inflation, perhaps for the exchange rate itself, and if you deviate from those targets, that itself doesn't automatically trigger action, but at least triggers discussion. That is one way of going about it.

Senator SARBANES. Those discussions and the coordination, do you think that should take place in a context of an OECD—that broadly, or is it sensible to limit it to just the few major industrial countries?

Mr. VOLCKER. Well, as a matter of efficiency, I think the burden has to be put on a few major countries, but it can be done within the environment of the IMF. In particular, in the IMF managing director and the IMF itself are involved in this process under the label of multilateral surveillance.

Senator SARBANES. Well, my time has expired. I'll come back on the second round.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Volcker, if Congress has the objective of lowering the trade deficit, bringing down interest rates, creating jobs, and stimulating increases in prosperity and real wages in this country, what do you think would be the most efficient and effective one thing that we in Congress could do to promote all those goals?

Mr. VOLCKER. Reduce the budget deficit.

Senator GRAMM. Say it again.

Mr. VOLCKER. Reduce the budget deficit.

TWO TRADE PROPOSALS

Senator GRAMM. Got it. Now we have basically 2 "trade proposals" before the Congress. There have been many bills introduced, but 2 that are getting the most attention. One of them sort of has the approach that we're going to impose tariffs on everything and lower these imports and protect American jobs.

The other is sort of a throwback to the infant industry argument where we are going to protect American industry for 13 years and let it rebuild its vitality.

Do you see any way that either one of these approaches can create jobs, generate growth, or raise the well-being of the average American?

Mr. VOLCKER. I think the obvious risk, Senator, is that they will do precisely the opposite, particularly when you put this in a context of not only the possibilities of retaliation which are very real, but the possibility that those kinds of measures will be considered a substitute for more fundamental measures and, in the process, I think upset exchange markets and financial markets in a way that would be counterproductive in terms of growth.

Senator GRAMM. Can you envision any realistic scenario where an across-the-board tariff on imports or a targeted tariff on specific imports, given the reaction of our trading partners, given the makeup of our economy—can you envision any way that that could raise real wages and increase jobs in the American economy?

Mr. VOLCKER. Not over any period of time, and I find it difficult to conceive of the circumstances where that would truly be productive even as an emergency measure.

I think you have to deal too with the fundamental point that the United States has been living beyond its means. We imported last year net about 3.5 percent of the GNP. When you are talking about reducing or eliminating the trade deficit, which I think we have to do over a period of time, you are talking about reducing in relative terms the goods available to consume in the United States by 3.5 percent. We have been living beyond our means.

That means that unless we get an increase in productivity, the standard of living of the average American is going to be going up less rapidly or actually going to have to decline to make up for that 3.5 percent.

So the emphasis has to be on improving productivity and efficiency or inevitably you're not going to increase the average wages of American workers.

Senator GRAMM. Can you envision how a 13 year protection of American industry to allow it to retool and become competitive again could be productive?

Mr. VOLCKER. No. I hadn't heard of that proposal. I wonder how they seized upon 13 years, but I think it gives the wrong signal.

My own conviction is the exchange rates are at levels so that American industry, by and large—or large segments of it ought to be very competitive internationally. And they should not be encouraged to think that there's always another bit of protectionism that's going to help them. They've got to get out there and compete.

When one looks at relative wages now and looks at relative prices at these exchange rates, it seems to me they ought to be able to compete.

Senator GRAMM. So one could correctly summarize your view as being that the time of Congress would be better spent trying to lower the deficit in the Federal budget rather than trying to protect American manufacturers from competition?

Mr. VOLCKER. I don't think there is any doubt about that. My fear is that if you don't deal with the budget deficit, everything else you do is going to be counter-productive because we don't have the savings in the United States to finance that budget deficit and to finance investment at the same time. If you don't deal with the budget deficit, you are forcing us to rely upon foreign savings and that is another fancy way of saying you're forcing a trade deficit because the only way you can draw on foreign savings is by running a trade deficit.

Senator GRAMM. Finally, let me move to a discussion of Third World debt. I can read you a lot of quotes that have been made about the need for reserving against troubled Third World debt, including a recent one from testimony by a representative of the GAO that in essence says,

A prudent first step before adopting any new initiatives would be for the regulators to mandate required reserves for a larger number of countries than is now the case. They have this authority. However, because of the limited use of this authority to date, further legislation may be required.

INCREASED RESERVES

It comes as no news to you that there are members of this committee that are looking at ways of trying to address the Third World debt problem. One proposal is to set up some corporation to engage in some kind of buydown—though I've never figured out how they would pay for it. Another approach is to set up a general reserving over a period of a decade, to combine that with removal of barriers to debt-for-equity swaps, and to coordinate that with our lending through the Federal Government to try to open up private investment, basically viewing the Third World debt problem as analogous to a corporation that's trying to grow with excessive debt rather than equity.

Would you sort of give me a general response to that approach—to both approaches?

Mr. VOLCKER. Well, I can give you a general response. You could find quotations from me speaking of relevance of increased reserves and capital of banks, partly in reflection of this problem, partly in reflection of other strains on their balance sheets. So I don't have any dispute about the desirability of moving as rapidly as practical toward more capital or more reserves.

I also don't question in any way and obviously support the idea of more private investment in these countries, both their own private investment and private investment from abroad, and that that can make a very important contribution to their growth and to a solution of this problem.

We may have some differences about how to go about it. You quote GAO. I wasn't familiar with that report. It said we, the regulators, have the authority to force more reserving if we wanted to,

not using therefore legislation. I suppose the answer is, I think we do have some authority and if we haven't used it in that way we don't think it's a good idea to use it in that way. We would encourage more reserving in general, but we have not wanted to identify it with particular countries or even with particular groups of countries and have felt that that is counterproductive.

Debt-equity swaps are proceeding. I don't think that in itself is likely to be of sufficient magnitude to solve the problem in any sense, but I think it can make a helpful contribution and, even more important would be to get some new equity capital in there bringing fresh funds with it from abroad. And we have been encouraging and working with those countries as much as possible. So has the World Bank. So has the IMF to encourage that kind of approach. I don't think there's any lack of will or pressure, so to speak, on that particular point.

Senator GRAMM. Have you looked at the proposals to set up some public or quasi-public corporation to act as an intermediary in terms of some secondary market or as part of any kind of overall buydown?

Mr. VOLCKER. I have looked at them to some degree anyway. I think you run into kind of threshold questions upon which I suppose philosophies can differ. It does seem to me to make those workable in the way that the authors or sponsors seem to envisage takes some kind of public guarantees or money.

I have assumed, rightly or wrongly, that that is not a very practical approach, that the United States and other parliaments were not going to provide that kind of public backing or direct public funds.

I also think you have another really more broadly philosophical problem of whether it is necessary or desirable to write down these loans and whether that is a good move as a general matter in terms of international financial markets moving ahead, a good move in terms of the growth and prosperity of the borrowing countries themselves that I think are going to be dependent upon access to capital from abroad not just now but in the long run. Do you really facilitate that by this kind of arrangement that involves a kind of forced write-down or semiforced write-down of the loans? We have not thought that that's very helpful.

Senator GRAMM. Thank you, Mr. Chairman.

Senator SARBANES. Senator Dixon.

Senator DIXON. Thank you, Mr. Chairman.

It's nice to have you before the committee again, Chairman Volcker.

If I could follow along that line, how can we provide to these debtor countries access to capital to help provide economic growth rather than capital simply to pay the interest on their old debts?

Mr. VOLCKER. Well, this question of providing capital to pay interest on their old debt I think is partly, frankly, a red herring. Any borrower that is in the market is in effect borrowing to pay interest on old debt. Money is fungible. You can use it for anything. The fact is, you have an obligation to pay interest on the old debt and I think it's important that those obligations be carried out and you need more money, I would say, to support investment. But

that is the marginal use of the money, not paying interest on the old debt.

In terms of our responsibilities here broadly defined and congressional participation in this process, it does seem to me, while I have not thought Congress is probably going to enact large special new programs, it is terribly important that you support the existing institutions that are playing an absolutely critical role in this process. And that pertains particularly to the World Bank and to the Inter-American Development Bank. If those institutions are not adequately supported, then I think we have lost a critical element in dealing with this problem.

It does take money, but that money also provides the leverage for policy changes that are even more fundamentally important than the money. But you need the money to go along with it to lubricate the process. And before talking about some brand new debt replacement plan that takes public money, I think the first priority is dealing with the here and now needs or the immediately foreseeable needs of the World Bank.

Senator DIXON. Well, following along with that, having in mind that most of the Latin debtor countries are struggling just to pay the interest on their present loans, do you see Secretary Baker's proposal as providing fundamental debt relief or do you see it as simply adding to the principal these nations seemingly cannot pay in the first place?

INCREASED DEBT

Mr. VOLCKER. I think the debt of some of these nations—not all of them, but the debt of some of these nations will go up. It has been going up. They have been going up at about 3.5 percent a year on the average total debt since the debt crisis broke.

Increases in debt of that general order of magnitude are manageable in a growing world economy. They are manageable if their own economy is growing at a reasonably vigorous rate of speed.

So I do think the kind of broad approach that Secretary Baker outlined, which would involve as he stated quite specifically some increases in debt and some provision of new credit, is manageable and consistent with a return toward normality in the markets eventually if certain criteria are met.

One of those criteria is sufficient rate of speed of world growth. Another is that internal policies in the borrowing countries are conducive toward their internal growth and efficiency. If you make those two major assumptions, some additions to the debt load can be managed.

Senator DIXON. As you know, Mr. Chairman, Senator Bradley recently appeared before this subcommittee and offered some suggestions. I would like to ask you whether you think that reducing the principal of these loans might make it more likely that the banks will eventually be repaid the remaining balances or are we simply fooling ourselves to believe the principal will ever be repaid?

Mr. VOLCKER. Well, they are two different questions I think.

I have no particular expectation that the principal of the loans will be repaid in any foreseeable time period any more than I have

that expectation that the debt of the U.S. Government is going to be repaid.

The question is whether that debt can be readily serviced in a functioning market. And that I think is a reasonable proposition. That is the objective. Not to get the debts all repaid.

Whether the kind of approach that Senator Bradley seems to support—which as I understand it is kind of a forced write-down of the loans—in the end helps or hurts is a matter of some dispute. One of the questions that arises when you begin writing them down—he suggested I think, for example, 3 percent a year and the borrower is apt to say, “Well, if you’re legitimizing 3 percent a year, why not 6 percent a year, or it would help me if you just did 50 percent right now.” And you get into that kind of an argument, which I don’t think is a very useful one.

The financial system operates on certain presumptions. One is that when you borrow money you repay it. Now sometimes that proves to be impossible, but I don’t think you dictate write-downs of loans that are serviceable.

Senator DIXON. Well, I think you’ve pretty well answered this question but I’ll ask it anyway. Secretary Baker believes that debt relief will not help much and will dry up the flow of loans and investment capital needed by debt-laden countries. Is that your opinion as well?

Mr. VOLCKER. Well, I think in many cases, yes. That’s what I’ve been saying. It’s a very tricky matter as to whether that kind of approach is productive or counter-productive.

These countries, as I said before, if they’re going to thrive and be part of the world economy—and they’ve got to be part of the world economy if they’re going to thrive—have to be part of the world financial system as well as the world trading system. They go hand-in-hand. Are you doing them a favor or not by writing down their debts, or are they doing themselves a favor? I think it’s very questionable.

Senator DIXON. Well, my final question would be, we used to have a market out there in Latin America. Now we are running a deficit annually about \$15.5 billion. So my final question is, can the right kind of capital assistance be found that would restore economic growth in the debtor nations and improve our export markets to those countries?

Mr. VOLCKER. Well, I think that would be both an object and a byproduct of restoring better growth to Latin America and it will take some capital flow. I would expect both more imports from Latin America and more exports to Latin America.

One of the things that we would like to see certainly—that’s got to be part of the general solution to the imbalance among industrialized countries—is that more of Latin American exports go to the rest of the world and relatively less to us, and more of their imports come from us and less from the rest of the world. We in the United States have absorbed the brunt of the inevitable adjustment in their trade that had to be made. I think we have absorbed a disproportionate share of it. Their exports to us have gone up, if I remember correctly, something like 30 percent over the past 4 years or so. They have gone up very little to Europe and Japan. And that kind of imbalance has to be addressed and, of course, it should be

addressed in substantial part by, among other things, the exchange rate change that's already taken place.

We should be much more competitive in Latin America now than we were 2 or 3 years ago. So we should have more opportunities there.

Senator DIXON. I thank the chair.

LATIN AMERICAN EXPORTS TO THE UNITED STATES

Senator SARBANES. Mr. Chairman, just to underscore your point, in the joint economic report, these are Latin American exports to major countries [indicating]. This line is to the United States and these two lines are Japan and Germany.

Mr. VOLCKER. It's been almost flat to Japan and Germany.

Senator SARBANES. Japan and Germany almost flat and here's this tremendous increase in the exports the United States has been taking from the Latin American countries.

Mr. VOLCKER. It may be worth making another point because I often hear this point, which is very real in terms of direction, as being a major explanation of our overall trade deficit. It simply is not. Latin America is not that big and our balance went adversely in Latin America and we absorbed a disproportionate part of the blow, so to speak. But when we have a trade deficit of \$150 billion, the \$15 billion deficit with Latin America only explains 10 percent of the deficit and in fact the deficit was only \$10 billion last year. It was \$15 billion in 1985. It declined already to \$10 billion last year out of a \$150 billion deficit.

So while the direction is right, this is not at the heart of our general trade and balance of payments problem.

Senator SARBANES. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, first, I ask unanimous consent that a statement I have be printed in the record at the beginning.

Senator SARBANES. Without objection, so ordered.

Senator PROXMIRE. I'll just read one short paragraph from it because it relates to a question I want to ask of the Chairman of the Federal Reserve Board.

The statement is as follows:

I believe it makes little sense for a debtor nation like the United States to borrow abroad in order for its banks to finance new loans to Latin American debtors so they in turn can service their present loans. A better policy is to have our banks build up their reserves against the loans they have already made. Then at least they will be in a better position to negotiate long-term debt workout schemes with the debtor nations.

Now that's the purpose of the legislation that Senator Gramm has introduced that I am cosponsoring and apropos of that, Mr. Volcker, I would like to call attention to one sentence in the General Accounting Office testimony made to this committee on April 2 on this subject.

The GAO said,

It appears to us that U.S. commercial banks as a whole have not reserved against or written down a lot of their LDC debt.

You confirmed that I think in your response to Senator Gramm.

On April 1, Charles Coltman of the Philadelphia National Bank in testimony before this subcommittee said the following;

LDC's are increasingly unwilling to commit themselves to levels of internal social and political sacrifices needed to keep their interest payments to foreign banks current, especially when such sacrifices imply a continuation of recent actual declines in living standards and no end appears in sight. From a lender's standpoint, we believe, as we have for some time, that losses of principal and interest are going to occur on the debt of these countries.

Now I'd like to ask you if you agree with that observation and then I would like to ask you about the specific legislation that Senator Gramm has introduced.

Mr. VOLCKER. I don't think I agree with the observation as a general matter, but to the degree that regional banks refuse to participate in these packages they may bring about that result.

Senator PROXMIRE. When you say you don't believe it as a general matter, you don't believe that LDC's are increasingly unwilling to commit themselves to levels of internal disciplines?

Mr. VOLCKER. No, I do not observe that. I do not observe that in Mexico. I do not observe that in Argentina. I have not observed that in Ecuador. I have not observed that in other countries.

As much of my statement says, I am encouraged by the degree to which they have corrected their budgetary problems, have changed their exchange rate policies, and have introduced structural changes in their economy.

I quite disagree with that. I think more progress has been made in this direction in the past few years than has been made in the previous 50 years and I think if people like that use that as an excuse for not lending to Latin America they are forcing precisely the result that they don't want.

Obviously, if you don't lend to them and they can't repay their loans, they won't repay the loans and they won't undertake the reform measures either. I think they're cutting off their nose to spite their face.

Senator PROXMIRE. Now the legislation that Senator Gramm has introduced—and he can correct me if I'm wrong—would provide the following. It would provide that the difference between the market value and the book value would be written down as a reserve over a period of 10 years, 10 percent a year.

My question is, do you believe that that is a practical and effective way of achieving the write-down which you said you supported in general terms?

Mr. VOLCKER. Well, I resist I think the idea of proceeding by the use of a mechanical formula of that sort. We don't have any disagreement about the end purpose, that we get more capital and more reserves behind bank risk in general. And while it is quite true that American banks have done relatively little country-specific reserving and that we have required relatively little country-specific reserving, it is also true that the general reserves and the general capital positions of American banks have increased quite a lot during this period. And we have looked at this a lot. You can look at the data until you get cross eyed. There are countries that have much more explicit reserving against country risk, but their capital positions overall probably have not improved any more than American banks and maybe less.

And what counts in the end I think is the total capital cushion, not how many reserves they have ticketed against a particular loan. And the trouble with kind of forcing this loan-by-loan is that you I think raise questions about—maybe unnecessary questions—about particular countries and particular loans.

Senator PROXMIRE. Don't you avoid that by making an across-the-board provision that you write down—10 percent a year, that seems to me to be a pretty moderate hit. We're not talking about 50 percent. We're talking about 10 percent per year for 10 years of the difference between the market value and the book value of these loans.

Mr. VOLCKER. I agree the difference between the quoted market value and the book value, 10 percent of that is not very much each year, but I'm talking to the principle of the thing.

TAX WRITE-OFF

Let me ask you a question. If you were going to push that and in effect you're saying you think there is some real loss in those loans—I'm not ready to say that, but I think you're saying that by that approach—would it then not be logical to permit a tax write-off for that amount of reserving? That would seem to follow the logic of your argument.

Senator PROXMIRE. Why not? My answer is why not?

Mr. VOLCKER. Why not? Well, then I might say we might have a meeting of the minds here. To the extent you're willing to provide a tax writeoff for reserving against these loans, I think you would see more reserving and that would make me happy and if you think they are entitled to it I'm not sure you have to have your formula then. Let's say that in these cases you could get some tax relief from the reserving.

Senator PROXMIRE. What concerns me about just the general statement they should write it down and there's a tax incentive for doing so is that you can slip off—where banks have been careless, where they have been imprudent, where you have a situation where they haven't diversified and accordingly have large losses, where they don't take a proportionate reserve cut, it seems to me as I say that 10 percent is a modest kind of suggestion.

Mr. VOLCKER. Well, it may be too small in some cases. That's part of the trouble with using that kind of a formula I think. When we do require reserving, as you know, it's much bigger amounts than that. But we have only required reserving in a case where clearly a country has demonstrated it's unable to service its loan.

Senator PROXMIRE. Well, you apparently feel that there's no real problem with respect to our banks here, at least real enough to mandate a specific reserve requirement?

Mr. VOLCKER. Well, I think there's a real problem. That's why we've been encouraging more capital and more reserving. The only argument is how you most effectively go about that consistent with the overall objective of restoring a normal situation in this market—voluntary lending as rapidly as possible.

Senator PROXMIRE. Now switching to exchange rates and trade. You say on page 5 of your testimony that "the constructive way to work in the needed direction would be to reduce our budget deficit

year by year paving the way for improvements in our trade account."

I take it that even though the value of the dollar has declined, you still believe that dealing with our budget deficit must be an important part of solving our trade problem. You have reiterated that several times this morning.

Tell us exactly why. Why does the budget deficit relate to the trade problem now that the dollar has declined?

Mr. VOLCKER. Because we have to release both real and financial resources to improve our trade position. To come back to that simple fact that we're spending 3.5 percent more than we are producing in this country, that 3.5 percent is the measure of the size of our trade deficit. How do we get that 3.5 percent of resources actually switched? That's what we're talking about.

Now changing the exchange rate changes the price incentives so long as it doesn't encourage an offsetting inflation at home or deflation abroad, but it moves in the direction of changing the price incentives. But people actually have to move. You've got to be exporting goods that would otherwise be consumed in the United States. So you have to get relatively less demand in the United States and relatively more demand abroad.

How do we get relatively less demand in the United States? Well, there are various ways you could do it. You could do it through presumably a restrictive monetary policy, but that would hit investment and you don't want to do that. You don't want to put interest rates up unless you have to. That's not the constructive way to proceed.

It seems to me the constructive way to proceed is by reducing the budget deficit and releasing the resources which are now used up in the budget deficit. That's the real resources.

Looking at it in financial terms, we do not have the savings in this country to finance both our budget deficit and our investment without borrowing from abroad. Now when you say reduce the trade deficit, you are saying reduce borrowing from abroad.

How are we going to reduce borrowing from abroad so long as we're running that budget deficit? What we'd have to do, again, is squeeze investment. That's the last thing we want to do. So you basically have the choice—do you want to squeeze the budget or squeeze investment? And faced with that choice, I think the answer seems to be unambiguous. The better thing to do is squeeze the budget deficit.

Senator PROXMIRE. My time is up.

[The opening statement of Senator Proxmire follows:]

OPENING STATEMENT
SENATOR PROXMIRE

HEARING ON EXCHANGE RATES
AND INTERNATIONAL DEBT
APRIL 7, 1987

Mr. Chairman,

Let me commend you for your industry in arranging this hearing, the seventh in a series your Subcommittee has held in the past five weeks to examine various international matters within our Committee's jurisdiction. Those attending these hearings should know that they are in preparation for a mark up of legislation dealing with these matters that will be conducted at the full Committee level later this spring. The legislation reported by our Committee will be taken up by the full Senate in the context of our debate on the omnibus trade bill.

I think it most appropriate that the final witness we will hear from before proceeding to our task of drafting and marking up legislation is the honorable Paul Volcker, the Chairman of the Federal Reserve Board. Mr. Volcker has for years warned the Congress and the country about our massive and inter-related

budget and trade deficits and the dangers these twin deficits pose to our future standard of living and national well being.

In February 1984, for example, Mr. Volcker told us:

"We are faced with two deficits in our budget and in our international accounts unprecedented in magnitude....We simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal deficits. Part of our domestic industry -- that part dependent on exports or competing with imports would be sacrificed."

How right he was. Over the last six years our over valued dollar, brought on in large part by our domestic budget deficits, has subsidized foreign imports and undermined our ability to export. Millions of workers have been displaced from their jobs and certain industries have been wiped out.

In fiscal year 1986, the U.S. budget deficit reached a record \$221 billion, raising our national debt above \$2 trillion, double its level in 1981 when President Reagan took office. During these same six years our trade deficit has grown annually reaching the \$148 billion level in fiscal year 1986.

This trade deficit means we are now in hock to the world. Only five years ago the United States owned \$140 billion more in net foreign assets than we owed. By the end of last year the \$140 billion in surplus was gone and we were in debt abroad more than \$200 billion. We are now the largest debtor nation in the

world. By the end of the decade our continuing trade deficits will raise our foreign debt to between \$600 and \$900 billion dollars. Servicing that debt means producing more than we consume and selling the surplus abroad to pay the interest on the debt. That will mean less consumption at home. I see an inevitable standard of living decline in future years as a result of the need to save more and consume less in order to service our national debt and to increase investment spending to develop our export sector.

At the same February 1984 hearing that Chairman Volker warned us of the mess we were creating for ourselves by our economic policies, the Reagan Administration told us not to worry. Beryl Sprinkel, then the President's chief economic adviser, told us the high value of the dollar stemmed not from budget deficits but from the confidence people had in America. He voiced little concern about the lost jobs and business bankruptcies that the Administration's policies were causing.

Mr. Volcker was right in warning us that our propensity to consume rather than save was going to get us in trouble. It has. I look forward to hearing the advice he will give us today. My own view is that there will be no easy way out of the domestic and foreign debt situations we have created for ourselves. Discipline and a willingness to set our financial house in order will be the first step. This must be accompanied by a willingness by our major trading partners to make complementary

adjustments in their economies. Specifically, Japan and West Germany must reorient their economies away from heavy export dependence toward domestic expansion. The Japanese must also do more to open their markets to us and the heavily indebted developing nations.

Before closing, I just want to make one comment on our current international debt policy. I believe it makes little sense for a debtor nation like the United States to borrow abroad in order for its banks to finance new loans to Latin American debtors so they in turn can service their present loans. A better policy, it seems to me, is to have our banks build up their reserves against the loans they have already made. Then at least they will be in better position to negotiate long term debt workout schemes with the debtor nations. That is the purpose of the legislation I introduced last week with Senator Gramm.

I also believe that it is imperative that the major debtor nations reform their economies in a variety of ways. This would include the development of deep and active capital markets to encourage sound monetary and fiscal policies, capital repatriation, and new equity rather than debt capital investments.

Thank you. I look forward to hearing from Chairman Volcker.

Senator SARBANES. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Chairman Volcker, as you know, this committee has had a lot of hearings on the issues of international debt and the extent to which either collectively or individually various countries face a liquidity or a solvency problem. You have used the Heinz-Proxmire legislation for a relatively small number of countries to put them in the most serious risk category. Then there's a broad middle category of countries, all of whom have liquidity problems and some of whom may face solvency problems.

It is the concern of the committee that the way the entire international debt strategy works, which importantly includes you, the other central bankers the IMF and the World Bank, to name most but not all of the players, doesn't offer the kind of incentives needed to bring more countries back from the risk of insolvency. There are an insufficient number of incentives for countries to reform their policies and probably not enough in the way of disincentives for those countries that refuse to reform their ways.

My question is this. Would it not be appropriate to make distinctions among countries in the large Other Transfer Risk category that reflect concerns among those countries—differentiate among those countries which are doing a pretty good job and who, because they are doing a good job, should get a little bit more flexibility and encouragement from the credit community, from the less good performers—I wouldn't put them by any means in the writeoff category—such that there is more stringent accounting for the credit extended to them?

Is there something inherently wrong with doing that as a more general rule rather than as you do it, which is, shall we say, heuristically?

Mr. VOLCKER. Well, I don't think there is anything wrong with the objective you're trying to get and I would say that's what we're trying to do. Maybe we don't do it very well in this very difficult judgmental area, but I guess I don't know how to do it any better.

There are two sides to what you're saying, which I agree with—that the country that is doing an effective job and internal reform needs some incentive, so to speak, to get on with it, and I fear that we may be falling short in that area.

BETTER PERFORMERS NEED INCENTIVE

Senator HEINZ. Well, I worry that the countries we are concerned with are really in 3 categories. There are ones that are working hard to recover; there are ones that aren't working too hard to recover; and then there are some others which haven't decided whether they want to work hard to recover and reconsider from time to time—

Mr. VOLCKER. Or they fluctuate from time to time.

Senator HEINZ. They backslide, and it's those that I worry about the most. I fear that unless you set up a more stringent system of categorization—stringent is the wrong word—offer more encouragement for those that perform and less encouragement for those that don't, that the tendency over time will be for countries to back away from doing what they need to do.

Mr. VOLCKER. I don't disagree with you, with the general concept again, but I'm not sure just how you do that mechanically other than what we're doing now. You can't bounce them in and out too quickly I think, and there is a certain amount of backsliding. That's inevitable. It's inevitable as part of any I suppose democratic or probably undemocratic government.

Senator HEINZ. Well, you may be right. Maybe it's impossible. Maybe Senator Gramm and Senator Proxmire and I are all on the wrong track.

Mr. VOLCKER. Well, I don't think you're on the wrong track conceptually. I just don't know what exactly you have in mind mechanically. Because my concern is that we may not be giving enough incentives to your good performers.

Senator HEINZ. Yes. Mine, too.

Mr. VOLCKER. That the World Bank may not have enough money—I think they have at the moment, but looking down the road, there may be a problem there. I think there is a problem currently that the better performers are not being sufficiently rewarded, at least in the sense of quick, speedy and assured bank negotiations. And the more that gets dragged out, that is no reward. That tends to discourage the borrowing country.

Senator HEINZ. Mr. Chairman, in the time I have left let me just ask a very specific question dealing with debt-equity swaps and the possibility of amending the Bank Holding Company Act to encourage or facilitate that.

There are a lot of people who note that there is a relative lack of good deals that the debtors are willing to see banks make. Nonetheless, they also note the uncertainty about valuation and impact on bank portfolios and limits on allowable investments under bank regulations.

One approach on the table would expand section 4(c)(13) of the Bank Holding Company Act to permit banks to take substantial capital positions in companies whose shares were obtained through debt-equity swaps and to hold them for periods of 10 years or more subject of course to Federal Reserve review.

Would such an approach open up many more deals to banks than they have now?

Mr. VOLCKER. Well, we're going to be looking at a range of possibilities along that line in the next few weeks, Senator, as a regulatory matter. It has not been my impression in the past that quantitatively these restrictions that have existed in law or regulation have been critical in diminishing the amount of debt-equity swaps for the other reasons you suggest.

But we want to review that whole matter and will be doing so in the next few weeks.

Senator HEINZ. So you will have more to report to us on that?

Mr. VOLCKER. We may make some changes, but we'll see.

Senator HEINZ. All right. Thank you, Mr. Chairman.

AMERICAN INDUSTRY AND EXCHANGE RATES

Senator SARBANES. Chairman Volcker, you indicated earlier that you thought American industry could now compete at the exchange rate levels that are prevailing. Is that correct?

Mr. VOLCKER. Yes. Broadly, that's my judgment, yes.

Senator SARBANES. Do I take it then that that means that you think that American industry could not have competed at the exchange rate levels that prevailed in the earlier 1980's?

Mr. VOLCKER. Well, I suppose it implies that they would have had a terrible job at the levels that were prevailing in 1985 or in 1984.

Senator SARBANES. Well, why did we not address those levels and try to come to grips with this mounting trade deficit problem and the worsening of our net asset position sooner?

Mr. VOLCKER. For a lot of reasons. I suppose I could refer you to a lot of testimony of mine where I was pleading to do something about the budget deficit then, partly for these reasons.

Senator SARBANES. Of course, the budget deficit has gotten worse, not better, and yet you've addressed the dollar question.

Mr. VOLCKER. Until this year there's very little correlation between my complaining about it and the actual performance. [Laughter.]

Senator SARBANES. Well, I'm going to turn to the Third World debt but I just want to put one question to you because of some earlier discussion on trade.

If other countries will not accept our exports, why should we accept theirs?

Mr. VOLCKER. Well, if that was literally true, if we couldn't export we couldn't accept their exports for very long because we would have nothing but deficit and we would have a bigger deficit than we have now and it's an unworkable system and it wouldn't work to our advantage or to their advantage. And I think that's the most general answer. The system isn't going to work very well if you have that kind of a situation persisting.

Senator SARBANES. So the answer really is we shouldn't. I mean, for the system to work, there's got to be reciprocity.

Mr. VOLCKER. For the system to work, there's got to be trade in both directions. That doesn't say it can't work and I think we are among maybe the most open of the large countries. I don't question that. And in that sense we have a competitive burden placed upon our industry. Now that can be offset to some degree by exchange rate changes or other factors, but I do not disagree with the proposition we are a relatively open trading economy.

I think that works to our advantage, if it isn't reflected in this enormous current account deficit we have. I don't think the world has changed very much in that respect over the past 10 years and we have not always run a great big deficit.

Senator SARBANES. Do you think it is reasonable to take contributions toward the security burden—defense and security burden—into account in judging the economic responsibilities which nations should assume internationally?

Mr. VOLCKER. Well, I suppose so. That gets into a series of very broad political questions, but certainly in just appraising economic performance and potential I think that's one factor you have to take into account.

Senator SARBANES. All right. Now do you think that the large current account surplus countries presently have assumed in terms

of their international economic responsibilities a burden commensurate with the strength of their national economies?

Mr. VOLCKER. Well, the shortfall that I am concerned about mainly is whether they are growing as rapidly as they reasonably could, particularly given the amount of unused resources they have.

Senator SARBANES. Well, that would be an international responsibility in a sense. It's one the United States for many years was very sensitive to.

Mr. VOLCKER. I don't disagree with that. I'm not sure they always see it that way, but I think it has that international dimension and I think it clearly is part of an international responsibility if you're going to have a growing integrated world economy. I think they also have a responsibility obviously to look at their own trade policies and I think you have two quite different situations there between Germany and Japan, one much more open than the other, as I understand it.

Senator SARBANES. Now you spoke earlier and fairly hard on banks not making further loans into the developing countries, but by your own statement there have been no new flows in 1985 and 1986.

Mr. VOLCKER. Right.

Senator SARBANES. So where are these developing countries going to find the capital with which to get on a growth pattern?

Mr. VOLCKER. Well, I think that is the question that debt performance raises. I think there were some special reasons in 1985 and 1986, but I think nonetheless the question arises and there's no point in lending money—to get partly to Senator Heinz' observation—no point in lending money to countries that are not among his plus performers. You don't want to do it to the minus performers. That's part of the whole incentive process. But when there are plus performers, if they are not able to find the financing necessary to support their growth and support the measures they are taking, they are obviously discouraged and will soon fall into the other category and they won't be able to service their debt.

So I think there is a mutuality of interests here that the whole approach has been based on the concept of a mutuality of interests between borrowers and lenders, a mutuality of interests both in performance and in seeing the performance financed. And what I'm a little afraid of recently is that conflicts of interest in the creditor community itself are sometimes obscuring that larger interest in providing at the end of the day the amount of funds that are necessary or in restructuring existing debts.

You have this problem which existed from the beginning which seems to be getting worse that you've got some small lenders that say, "Look, we can have the best of all worlds. We will continue to receive the interest and have our debt paid off and we will not put up any new money. We'll let somebody else do that." If enough people do that, the whole system breaks down.

LOAN DISCOUNTING

Senator SARBANES. Well, now some banks are selling these loans at a discount, is that correct?

Mr. VOLCKER. To some degree, yes.

Senator SARBANES. How can we work out a system whereby the debtor countries get the benefit of that discount? Under the current arrangement, the bank is prepared to take the loss by selling it at a discount but the debtor country remains confronted with the full value of the debt.

Mr. VOLCKER. That's correct. And if he wasn't, of course, the loan would be worth less than the current quoted value.

Senator SARBANES. But they then remain with this debt overhang and they have no way to get on this growth pattern. The approach you're following is not putting them on a growth pattern because they're not getting any new commercial bank lending by your own statement.

Mr. VOLCKER. Well, I think they are getting on a growth pattern and I discuss that in my statement—not as rapid and as strong as I would like to see it. That's partly because the world economy has not been on a growth pattern as strong as one would like to see it.

But you're back to the question whether in the end of the day it helps or hurts to have officially sanctioned or required write-offs of the debt and not just write-offs of the debt on the books of the creditors but forgiveness in terms of the borrowers. That raises a very big issue and while that undoubtedly has happened and will happen in some specific instances, imposing it or encouraging it as a general matter I have thought would be counterproductive.

Now indeed, if new money is not provided, if the banks don't get together a new lending program, the inevitable result is that some of these things are going to have to be written down.

Senator SARBANES. Do you think the large current account surplus countries have any responsibility other than the expansion of their own domestic economies in trying to address this problem of the debt overhang in the developing countries?

Mr. VOLCKER. Well, I think the more that they can do to encourage the flow of funds in that direction, the better off we will be and the world at large will be. Certainly they have a responsibility that I referred to earlier to open their markets to these countries for their exports.

How much you can expect in terms of the financial flow diversion is a question because they will argue why should they—they may have a surplus now, but why should they take on a disproportionate risk in lending to those countries? I think they will provide the liquidity if somebody else provides the guarantees is often the answer you get, but why should they take the risk as well as provide the money?

And I think the conversation kind of sits there deadlocked on that point.

Senator SARBANES. Well, let me simply observe, it seems to me that they do have a responsibility and it really comes right back to virtually the very first sentence in your statement—problems of economic growth, balance of payments adjustment, protectionism and international debt are intertwined and that it becomes relevant if you're going to have an international economic context in which you can be on a growth pattern, which is the only one that is really productive and constructive, it seems to me they have to carry some of these responsibilities.

Mr. VOLCKER. Well, I don't doubt that. It's just a question of how much we can practically count upon and in that connection I think I should point out that in a number of specific cases—in two or three, where particular debtors are arranging a financing program, the Japanese have agreed to provide a disproportionate amount of official financing, including the financing in some projects of local expenditures as well as foreign currency expenditures. That's rather unusual behavior for official creditors and I want to point out at least to that extent some initiatives have been taken.

Senator SARBANES. To the extent that they do that, though, you would say it ought not to be on a tied basis, should it?

Mr. VOLCKER. Yes. Now some of these projects—for instance, the pipeline in Mexico, they are interested in because it will facilitate the export of oil to Japan that they have to buy anyway. But the willingness to finance the pipeline and to finance at least a portion of the local currency expenditures, which are most of them for that pipeline, is obviously a constructive initiative even though it's argued that they have some self-interest in seeing that the pipeline is built too.

Senator SARBANES. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Volcker, I want to go back to the question that, if nations did not buy our goods should we buy their goods. As I heard your answer—I just want to be sure that we've all got the answer in mind—your answer wasn't a question of whether we should. Your answer was that we couldn't.

Mr. VOLCKER. Right.

Senator GRAMM. If no one would buy our goods, then we couldn't sell anybody goods in the long run.

Mr. VOLCKER. That is correct and we wouldn't have any money to buy their goods.

Senator GRAMM. In essence, this whole idea that we're running a trade deficit and these dollars are going abroad and being lost and being eaten up by beetles or something is simply a failure to recognize that in essence the dollars are making a round trip, because the balance of payments under a flexible exchange rate, for all practical purposes, is always in balance, and for every dollar of trade deficit in the investment account we're bringing dollars in that have funded the Federal deficit and the economic recovery. Isn't that right?

Mr. VOLCKER. Yes. The inflow of money has to equal the outflow, yes.

Senator GRAMM. So what we're really saying is that the protectionist approach to this trade deficit, in essence, other than building a great wall around the United States, which is a paradox in that at the very moment in time that Communist China is recognizing that trade is the answer and they are coming out from behind their Great Wall, there are so many people who want to build a great wall around the United States—but other than just stopping trade totally, unless you're going to eliminate the capital inflow, you're not going to be able to eliminate the trade deficit. Isn't that right?

Mr. VOLCKER. We can't have it both ways. We can't eliminate the trade deficit and continue to have the capital inflow.

Senator GRAMM. And given our current budget deficit, without the capital inflow, we would no doubt have higher interest rates, more sluggish growth, and probably a recession?

Mr. VOLCKER. Yes.

Senator GRAMM. Couldn't you even say, if you were in an expansive mood, that we have literally bled Europe and Japan to fund our own recovery and our own deficit in the balance of payments?

Mr. VOLCKER. Well, that's a colorful phrase. I don't think they've felt particularly bled. I mean, they've been quite willing to do it. But it's not a healthy and sustainable set of circumstances either from their point of view or our point of view over a period of time.

Senator GRAMM. But they have done it because we have had the highest real interest rates in the world.

Mr. VOLCKER. That is—I don't know if that's true today, but—

FUNDING DEFENSE

Senator GRAMM. Let me ask you a question about defense. Obviously we want people to bear their share of defense. How to get them to do it has been a classic problem in the postwar period.

But if we impose an import fee, who pays it?

Mr. VOLCKER. Well, that gets to a question of how all the prices react and all the rest, but basically the consumer pays it and the Government will get the revenues.

Senator GRAMM. So if we decide we want the Japanese to spend more on defense and we impose a fee on their goods, then Joe Brown in Waxahachie, TX, ends up paying that fee. Is that not right?

Mr. VOLCKER. Yes, it's a way to tax him to pay the Government I suppose.

Senator GRAMM. But Joe Brown is nonetheless paying?

Mr. VOLCKER. Joe Brown is paying, yes.

Senator GRAMM. So unless you find some way to change their governmental policy other than affecting their economy in some kind of punitive way, you're simply taxing our own worker, our own consumer, in trying to pass this cost on to somebody else; isn't that right?

Mr. VOLCKER. Yes.

Senator GRAMM. Since Senator Proxmire brought up our bill, I'd like to go over in my remaining time basically what the bill does.

What the bill is trying to do is set up some kind of systematic way to address this Third World debt problem. I agree with you that all the things you're talking about need to happen. But as I look at the jurisdiction of our committee and its responsibility, obviously a prime responsibility of this committee is to protect the safety and soundness of the domestic banking system.

And what this bill, in essence, does is it takes two current loan categories—Other Transfer Risk Problems and Substandard—and it takes those loans as a composite, and it sets up really a measure or sets a procedure for trying to determine what is the actual or real value of the exposure relative to what the book value is, specifically leaving out changes in value caused by a difference between the face interest rate, and the market rate, which we discussed earlier.

It sets up seven criteria to try to do that. Obviously, one is the secondary market price when the asset is being sold. We look at other factors such as rescheduling. We look at the export earnings of the country. We look at foreign exchange reserves held by the country. We look at the external debt service history of the country. And we let the bank regulators look at other appropriate factors as well.

But the idea is to direct the bank regulatory agencies to try to come up with some way of assessing, based on the secondary market, based on the performance of the countries in this category, what the actual value of this asset is.

Then we set up a procedure whereby over a 10-year period you would have to build up a general reserve, not identifiable with any country—out of a belief that to do that may even encourage the country to default, so we build up a general reserve—

Mr. VOLCKER. But if I may just interrupt to ask a question, you may call it a general reserve, but my understanding was that it's computation would be very much related to a particular judgment by the regulatory authorities based on these criteria of a particular country as well as a general reserve.

Senator GRAMM. Well, that's correct, Mr. Chairman, but that particular country would be part of this composite which is made up basically of these two categories—Other Transfer Risk Problems and Substandard.

Mr. VOLCKER. But we would be rating—

Senator GRAMM. That's right.

Mr. VOLCKER [continuing]. Each of those countries and assigning kind of a numerical total to every country.

Senator GRAMM. Well, in terms of the setting of the general reserve requirement on this Third World debt, it would be for a composite, even though obviously to calculate the composite you've got to look at each individual country, just as you would look at each individual asset in auditing a bank and in determining how you're going to value that asset on the bank's books.

The second thing that the bill would do is to try to clear the way for more debt-equity swaps, and I think we could debate about how big this could be. Senator Bradley the other day when my time ran out said, "Well, the whole equity market in Mexico was only \$6 or \$8 billion." But that doesn't mean there's not tremendous equity there.

I would submit that while Pemex is a governmental entity, that there are a lot of banks today that would be willing to take Pemex reserves in exchange for their loans even though those reserves might be valued higher than the whole equity market in Mexico. So I'm not sure that this is a solution, but I see it as an important movement.

Then, finally, to have a more precise definition of what our objective in nation-to-nation lending is, the bill would set out a policy that as part of this nation-to-nation lending, we're going to call on those that are recipients of loans that are guaranteed, directly or indirectly, by the taxpayer—that we're going to call on them to open up their markets for private investment.

Now it seems to me that the advantage of this approach would be that, No. 1, we would be building up our domestic reserves. We

have a tremendous amount of flexibility for the banking agencies in terms of measuring this decline in the value of assets. We promote a secondary market, and I guess I look—I remember when I was a Member of the House I represented a city, Mexia, TX, which had had a big oil boom in the 1920's and gone out and built a lot of public services and the oil played out and the town went bankrupt and defaulted on its bonds, and those bonds ended up passing through the banking system and a secondary market. They ended up in the hands of specialists and then when Mahaya reached a point where they wanted to do some expansion and go out and borrow additional money they ended up in essence buying this debt back or paying it off—I don't remember exactly what the percentage they paid off was—but what in essence happened was that this debt had circulated through the banking system, the losses had been dispersed, Mexia paid off the dealers who ended up with it.

It's not hard for me to imagine that if we had a general reserving, we would have a larger secondary market, you would have institutions and individuals that would specialize in Third World debt and collecting it, and in the process we could wash this whole problem through the banking system over a decade or two, rather than maintaining the current status quo situation.

Mr. VOLCKER. Would you feel that as part of the plan, as I asked Senator Proxmire, that a bank would be entitled to a tax writeoff?

Senator GRAMM. I would say that as long as they are holding general reserves, no. If they sold the asset in the secondary market and took a loss on it, at that point under current law they would be entitled to the writeoff.

Mr. VOLCKER. Under current law they would be entitled then.

Senator GRAMM. But I would say as long as it was just simply generally reserving, no, I wouldn't give it to them.

Mr. VOLCKER. Well, it's not exactly general reserving if the regulators are telling them under your approach, as I understand it. If the regulators are saying, "It's our judgment that you reserve," I think this raises a point of principle, I suppose. If we are telling them to reserve and directing them to reserve, and implying there's some kind of a loss there, why shouldn't they get a tax writeoff at that point?

Senator GRAMM. Well, if you raise the reserve requirement tomorrow, would they be able to write off the general increase in the reserve requirement?

Mr. VOLCKER. Well, the reserve requirement against deposits isn't relevant to this. But we haven't got a mechanical reserve requirement against loans.

Senator GRAMM. But I'm saying though, in essence, that this reserve is required because the deposits that in essence have provided the resources for those loans are at greater jeopardy because of the question concerning the serviceability of the loans, and if one looked forever down the road maybe even collectibility.

Mr. VOLCKER. Well, obviously, this gets into an area where there is no precise answer. I would have been in favor of less rigorous treatment of general reserving by banks as part of the tax bill last year, and so expressed myself. But I think you go a step further here when you direct a particular amount of reserves and say

you're not able to use that in terms of taxation. The Government is saying, on the one hand——

Senator GRAMM. Well, my time has expired, but if I may, I guess my feeling about the tax provision last year was similar to yours, that at the time we wanted to build up reserves that that change may not have been fortunate in relation to this particular problem.

But given the makeup of the new tax bill, which is when you take the loss officially is when you are able to claim the writeoff against it, then I don't see an inconsistency between building up the general reserve and not allowing the tax writeoff until the loss is actually realized.

TAX INCENTIVE

Mr. VOLCKER. Well, from my standpoint—I don't want to prolong this either, but from my standpoint, it seems a little odd and peculiar and maybe not constructive to give a tax incentive to actually sell it. If a bank wants to keep it, if its evaluation is that this is a good loan, why bias that decision by the tax treatment?

Senator GRAMM. Well, that same incentive exists with every other asset they have today. They don't get the tax writeoff if they have to reserve against it. They do if they sell it off at a loss. So it's perfectly—I mean, your argument is an argument against current tax law in banking it seems to me.

Mr. VOLCKER. I don't think that's fully true. They can sometimes get a loss without actually selling the asset. The question is, when in the judgment of the IRS it really is a bad asset. If the IRS followed I think the reasoning you seem to have, they ought to permit the tax writeoff, but I'm not enough of an expert. I think it's a relevant question in your approach.

Senator GRAMM. Well, had I been in control of the tax bill last year, which I was not, even though the final product was one I supported, I think the change in tax law with regard to reserving at banks probably was not a good idea.

Mr. VOLCKER. Well, I don't want to get into it any further, but I do think it's a relevant consideration once you begin commanding reserving.

Senator GRAMM. Thank you, Mr. Chairman.

Senator SARBANES. Mr. Chairman, I just want to make a couple of points and ask a couple of questions. You have been very generous with your time this morning.

First of all, the point on the security contribution that countries are making, in my view, assuming they are not carrying a proportion of burden, they can rectify that in two ways. One is to carry a heavier defense burden. The other alternative is to carry more of the economic burden internationally.

If you factor it in and it is, as you indicated, a relevant consideration, it seems to me reasonable to turn to a country—obviously Japan, which is limited to one percent on the defense contribution, and say, "Well, we won't necessarily press you to rearm, but we do press you to take more of the international economic burden in terms of making the international economic system work."

Do you see anything unreasonable in that?

Mr. VOLCKER. No, and I think, of course, we do say that and to a degree I think they may even accept it. But then you get to a question of amount. I'm not sure they accept it philosophically, but they have been increasing their aid programs at least.

Senator SARBANES. Well, I think their perception of what constitutes a significant amount in my view does not measure up to the strength of their economy in the international economic context.

Mr. VOLCKER. I am sure there would be a wide gulf between what they thought was an appropriate response and what you thought was an appropriate response, even if there was agreement about the direction.

Senator SARBANES. I am interested that one of the threshold questions you raised about an intermediary was that to be workable it would need some public guarantees. It would be my view that a larger proportion of that should come from the large current account surplus countries.

But in any event, you raised that as an objection as to whether that's feasible. And yet in addressing the reserving question you're obviously influenced in how you respond to that whether it's permitted as a tax writeoff, which of course represents in a sense a commitment of public funds.

Mr. VOLCKER. That is indirectly I suppose, even when they have a loss, if the loan really did go bad, there's no question banks should get a tax writeoff. Nobody would question that, even though it's inherent—

Senator SARBANES. But you said on the reserves that you would look at it more positively if they could get a tax writeoff. If they get that, then there's in effect a commitment of public moneys and yet one of the objections you raised to the intermediary was that it might involve public money.

Mr. VOLCKER. But what is different I think is that in this case the Government is telling the banks that they have to put up this money. Whatever their judgment is, you put it up, because that's our judgment. We think there's something the matter with the loan to "x" degree and you are commanded to put up the money.

Once they are commanded, then I think it's a question of if it's the public's judgment—the Government's judgment that it's bad for that purpose, why isn't it also bad for the tax purpose?

Senator SARBANES. Well, to the extent we did that, that cost would be borne 100 percent by our taxpayers, is that right?

Mr. VOLCKER. Well, it's whatever the tax rate would be. The whole loss wouldn't be offset by taxes.

Senator SARBANES. By U.S. taxes.

Mr. VOLCKER. Well, at the margin for a U.S. bank presumably it would save them whatever the marginal corporate rate is now.

Senator SARBANES. If you had an intermediary facility toward which we made a contribution, then our burden would be whatever the percentage of our contribution was.

Mr. VOLCKER. Well, I think you get it both ways then, if I understand this correctly. If you have this facility which was taking these loans at a discount—the banks were selling the loans at a discount, just in the normal course they would get a tax writeoff. Then the Government is turning around and guaranteeing, as I un-

derstand it, in part or by some device, directly or indirectly, that facility, too.

But I certainly presume they would get the tax benefit that you're talking about by simply selling it at the discount to the facility in the first place, which would be current tax law.

Senator SARBANES. We have had testimony before this committee that the way the Third World debt issue has been handled in effect sacrificed our manufacturers and farmers and other producers to the needs of our financial institutions. Particularly, the austerity program in the early 1980's resulted in imposing a regime on the debtor countries to enable them to meet their debt obligations to financial institutions, American and others, but that the consequence of that was, in effect, a crowding out, if you want to use that term, of American producers and that indirectly they were carrying the burden for meeting the needs of the financial institutions.

Now you make a point in your testimony that the combined current account deficit of the Baker 15 countries declined from the \$50 billion range in 1981 to 1982 to almost zero in 1984-85. Without assuming that the \$50 billion range was appropriate, is it necessarily a positive development from the standpoint of economic development of the debtor countries and from the standpoint of U.S. producers—I guess, really, what is your view of this very sharp point that was put to us by American producers that they in effect were paying for this unfairly, that too much of the burden was falling upon them in addressing this situation?

Mr. VOLCKER. Well, the first response would be, to the extent that American producers and other producers—but let's say specifically American producers have been at the receiving end, so to speak, of reduced imports by those countries or compete with their exports, to a considerable extent it was inevitable.

These countries were borrowing a lot of money for an extended period of time and that worked, in a sense, to the advantage of those U.S. producers then because we were pretty competitive and pretty close to Latin American markets, and that's all fine so long as it lasts. But when people refused to lend them that amount of money, that particular music stopped and I don't think it's a question of equity or lack of equity that the earlier exports were in part built upon unsustainable amounts of lending. And when that adjustment takes place, it's not a very happy circumstance either for the borrower or for those American firms or others who are caught in the swivet, so to speak. There's no doubt that some firms were hurt in that process.

I think the degree of that problem relative to other factors in the balance of payments is often exaggerated, as we discussed earlier, but there is no question that American companies, either competing with imports or exporters, were placed in a more difficult position by the difficulties in Latin America and the need for them to reduce imports and increase exports. That is true.

I think the only question is how big a factor that is amid all the other factors affecting our trade balance. And I would say not terribly big. It's a small fraction of our whole problem but it is there. But it had to be put on a more sustainable basis. There was no way that these countries were going to continue to borrow \$20 or \$30

billion a year net because people weren't going to lend to them unless the Government wanted to take that over, and I saw no sign of that.

So it was a difficult adjustment for some companies, but I think to a substantial degree it was inevitable.

Having made that adjustment, now obviously the common interest is to move ahead and get some growth and get more export markets.

Senator SARBANES. Do you think the gold held by the IMF ought to be used in some way by them to address the Third World debt question?

Mr. VOLCKER. Well, that has been done historically in a very minor way. I don't have any very strong position on that. If somebody came up with a sufficiently imaginative and constructive idea in that connection, one might want to look at it.

I think it is fair to point out, and what they would point out immediately in response, is that the IMF has been active in this problem in extending credits and that it is not inconvenient for them to have a substantial net asset position which in their case is represented by gold in terms of the credibility of their own balance sheet and position. And I think there's a lot to that. One would want to be pretty careful about how one expended their assets.

Senator SARBANES. Would you treat the debt of sub-Sahara African countries in an entirely different way than the rest of most of the balance of the developing world debt?

Mr. VOLCKER. Well, I think basically that African debt, to oversimplify, is so different in degree that it is different in substance. That's largely a problem of public credits as opposed to mixed but largely private credits for these—we call them developing countries, but many of these heavily indebted countries are middle-income countries on their way toward—certainly at least partially—industrialized countries.

Brazil is a big, strong economy. It is not Zaire or the Sudan or Tanzania and it is a very different circumstance and you basically face a problem of public financing and I think ultimately some public write-offs in the case of Africa.

Senator SARBANES. Senator Graham.

Senator GRAHAM. Mr. Chairman, I apologize for my late arrival. I was attending another committee meeting and if I ask a question which has previously been asked I will defer to the record.

I have 2 questions. One, at some of our previous meetings there has been rather sharp disagreement on the question of just what is the economic future for particularly countries in Latin America. One school is saying that we are dealing with a temporary liquidity problem; others that we are dealing with almost insolvency.

Is there through your institution or elsewhere a monitoring, a series of agreed upon indicators, of the economic health of these countries that policymakers could look at over time to make judgments as to whether we are dealing with a case of pneumonia or terminal cancer?

Mr. VOLCKER. Well, I think we've got a lot of indicators and we follow these countries. We don't have that kind of scoreboard where we put them up on the wall and say, "You've moved from illness to your death throes," or vice versa and I don't think it's

quite as mechanical a process. But obviously, we follow them as closely and as fully as we can.

Basically, just to get to the substantive point, I suppose our whole approach is premised on the assumption and the analysis that by and large these countries are in a position to restore rather full creditworthiness over a period of time consistent with their own growth and prosperity. That is the basic judgment that underlies this approach.

Senator GRAHAM. Let me ask a second question related to a specific regional area and that is Central America.

There have been statements attributed to governmental and private sector leadership in this region that they are being held to a more rigorous standard of repayment than are other larger countries that, for instance, Costa Rica which has a very high per capita debt but as a small country not a large aggregate debt—has been required to make commitments as to economic reform more stringent than a Mexico, for instance.

(a) Do you concur that there is such a feeling in the region of difference in treatment? (b) If that feeling does exist, do you believe it's justified? (c) If it is justified, do you have any recommendations of what we ought to do about it?

Mr. VOLCKER. Well, I have not sensed the point that you're making. That doesn't say they don't complain about that. I am not as familiar with some of those Central American countries as I am with some of the larger ones. But I have not—maybe only because I personally see less of them, I have not been particularly aware of that complaint.

I am not aware of it in substance. I think there are common problems. I think each of the borrowers is inclined to feel that he is put upon a little bit by the IMF or the World Bank or whatever. I think they try to be even-handed and that's about all I can tell you.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator SARBANES. Well, thank you very much, Mr. Chairman. It's been a very interesting morning. We appreciate your coming before the committee.

The committee stands adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM
DAVID C. MULFORD

Question: You discussed measures that Germany and Japan have agreed to take to stimulate growth and domestic demand. These measures seem focused on the medium-term future. Please provide your estimates of when we will see a response from these measures on the U.S. economy and how great will it be? Will it make a significant impact on our trade deficit?

Answer: Our approach to the reduction of external imbalances -- notably the U.S. deficit and German and Japanese surpluses -- is of necessity a medium-term one, in the sense that it has a multi-year time frame. This simply mirrors the fact that the emergence of these large imbalances also occurred over a span of years. The U.S. trade deficit went from \$28 billion in the recession-influenced year of 1981, to \$148 billion in 1986, both on a balance-of-payments basis. The current account showed similar deterioration, from a surplus of \$6 billion to a \$141 billion deficit, over the same five-year span. These very large swings will take time to reverse.

It is extremely difficult in present circumstances to estimate timing or strength of effects of stronger foreign growth on the U.S. trade balance. This is because stronger growth interacts with other elements in our trade picture, notably exchange rates and the debt situation. We believe these 3 factors are the main influences explaining the deterioration in the U.S. trade deficit.

The major ways in which growth, exchange rate change, and the debt strategy are mutually reinforcing are the following:

First, stronger growth will reinforce and strengthen the effects of the substantial exchange rate change we have already had.

- Exchange rate changes have been the major factor in a levelling-off of the trade deficit in value terms, and we expect a decline in the deficit of perhaps \$15 billion or so this year.
- We have also seen a turnaround in trade volumes, with net export growth expected to contribute 1 percentage point or so to U.S. GNP growth this year. This positive contribution contrasts with the negative contribution of net exports to U.S. growth during 1981-86.

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However, U.S. import prices have not reflected exchange rate changes to the extent we would have expected, in part because exporters to the U.S. are shaving profit margins in an effort to retain market share. Stronger growth abroad will give foreign producers alternative markets to sell in, thus reducing pressure to shave prices and profit margins to retain U.S. sales.

Second, stronger growth in the industrial countries is an essential component of the debt strategy. Adjustment to debt difficulties by LDC debtors, which were major U.S. export markets, have been an important factor in the deterioration of the U.S. trade balance. Stronger growth in their export markets other than the U.S. will improve their export earnings and revive export opportunities for U.S. products.

Question: A year and a half after G-5/G-7 agreement on policy coordination, progress toward implementation is not evident? When will governments agree on targets and performance measures? What are Treasury's plans for consulting with the Congress on these measures?

Answer:

At their meeting in Tokyo last year, the seven Summit countries put in place improved coordination arrangements based on indicators. Since then, we have agreed on a process for implementing the Tokyo Accord and are now preparing a report for the Venice Summit on progress to date.

Naturally, the process of making coordination more effective is evolving. The process began with the selection of a broad range of economic indicators to sharpen multilateral surveillance. Ministers and Central Bank Governors have met several times in the past year to review policies and performance. In these meetings, the indicators have helped focus discussion on the most important issues, and have facilitated understandings on additional measures to be taken.

The Louvre Agreement on February 22, reaffirmed and enhanced at the G-7 meeting on April 8, is as an important milestone in implementing the Tokyo Accord. The countries involved announced concrete measures to foster increased growth, reduce trade imbalances, and promote currency stability. In particular, Germany has increased the size of the tax cuts scheduled for 1988. Japan has agreed to implement a comprehensive economic program to stimulate growth, and has announced plans for a large supplemental budget. The U.S., of course, must also do its part by continuing to reduce the budget deficit, resisting protectionist pressures, and implementing measures to improve its competitiveness. The major countries have also agreed that their currencies are within ranges broadly consistent with economic fundamentals, and have undertaken to cooperate closely to foster stability of exchange rates.

Throughout these past months, the Treasury Department has worked closely with the Congress to ensure that more effective international policy coordination will advance U.S. interests. Together with other senior officials from the Department, I have testified frequently on the process we have established and on the undertakings it has produced. We have been candid about the objectives mutually agreed upon, and about the commitments we have accepted. In the future, we will continue to take account of the concerns of the Congress and to report fully on our coordination efforts.

QUESTION:

Many countries' debt has been rated as impaired -- Other Transfer Risk Problems or below -- for some time, yet only a handful of hopelessly indebted countries have required reserves set aside under the International Lending Supervision Act. After a country's debt has been rated for a substantial period and the country is not making substantial progress toward recovery, is it not appropriate for banks to begin to reserve against those loans to cover the mounting risk of losses?

ANSWER:

Section 905(a)(1) of the International Lending Supervision Act authorized the banking agencies to require a banking institution to establish and maintain a special reserve whenever in the judgment of the agencies:

- (A) the quality of such banking institutions' assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors, among others, as-
 - (i) a failure by such public or private borrowers to make full interest payments on external indebtedness;
 - (ii) a failure to comply with the terms of any restructured indebtedness; or
 - (iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or
- (B) no definite prospects exist for the orderly restoration of debt service.

Although many countries have had difficulties in meeting their external indebtedness, only seven countries at this time have experienced difficulties severe enough to meet the definition of Value Impaired, which mirrors the language of Section 905(a)(1). (A reason that the list appears so small compared to the total number of countries experiencing protracted repayment problems is that many countries with very serious economic problems do not owe any debt or only de minimus amounts to the U.S. banking community.) The assignment of a Value Impaired rating is a serious criticism of a country's credit standing, the effect of which is to hamper a country's ability to raise funds.

The bank examiners look at the overall quality of a bank's loan portfolio, which may include some loans in the Other Transfer Risk Problem or Substandard categories. If the overall asset quality is weak, the examiner would encourage the bank to increase capital and general reserves in recognition of the increased risk of both international and domestic credits in today's environment.

At the same time, banks can and do increase reserves on a voluntary basis.

Question:

Debt-equity swaps have been occurring to only a limited extent. In part this is due to the supply of attractive equity and partly to the unwillingness of governments to see it swapped with foreigners or as a means to repatriate capital. But where swaps have been aggressively pursued, as in Chile, it is possible to achieve conversion of considerable debt in a short period of time. Does the Treasury favor an expansion of this mechanism for U.S. banks as one more way to address the debt problem? What steps can be taken to encourage this development?

Answer:

The Treasury is firmly on record in supporting the development of the debt/equity swaps. Secretary Baker and other officials have made a number of strong calls for increased equity investment and debt/equity swaps in the debtor nations in order both to limit total debt burdens and to boost potential growth. We believe that debt/equity conversions can play an increasingly important role in supplementing the debtor reforms and new financing which are essential elements of our international debt strategy.

Secretary Baker has stressed the advantages of equity investment, both portfolio and direct, as well as debt conversion at important international meetings and in his discussions with financial officials of the indebted countries. Treasury has encouraged the IMF and the MDBs to become actively involved in this area, and the IFC Board recently approved participation in a new type of fund - The First Philippine Fund - which will convert bank-held debt into equity investments. OPIC has given political risk insurance on assets to be acquired by this fund.

We believe that these efforts are beginning to show results. In 1986 some \$2.5 billion in debt conversions occurred within four of the major debtor nations alone. This is likely to increase dramatically as other nations begin to permit conversions and innovative mechanisms, such as conversions through special mutual funds, become more widespread. Of course, for these funds to flourish, countries need to offer a wider range of equity investment opportunities than they now do.

QUESTION:

My understanding is that there are regulatory and accounting practices that cause U.S. banks to hold back from undertaking swaps. The concern is that a swap would be considered a recognition of lost value, perhaps resulting in very substantial write-downs of loans swapped or even reevaluation of all other loans to a country in which a swap occurred. Yet under the Baker Plan, new loans are made to countries that are rated by regulators but considered to be improving their repayments prospects with no presumption of lost value. Should regulatory changes be pursued to promote debt-equity swaps on this same basis?

ANSWER

There are two major accounting questions associated with debt/equity swaps. First, how to "fair value" the equity received for the debt conversion. This issue is being considered by the American Institute of Certified Public Accountants (AICPA) and should be resolved by this summer.

Second, there is the question of "contamination", i.e., if the fair value of the debt/equity swap is less than the par value of the original loan, should the bank mark to market (devalue) the other loans to that same debtor still on its books? I believe the AICPA clearly answered that question in 1985 when it said that so long as the bank has the ability and intent to hold the loans until their maturity, there is no need to mark them to market.

We believe that the regulatory environment is flexible enough to facilitate debt/equity swaps and that no change is needed to promote those transactions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
CHARLES L. COLTMAN, III

- Q. 1. Many countries' debt has been rated as impaired by regulators -- Other Transfer Risk Problems or below -- for some time, yet only a handful of hopelessly indebted countries have required reserves set aside under the International Lending Supervision Act. The regulators require no particular action by banks to increase capital as a result of this exposure.

What has been the reserve policy of your bank with regard to debt for which mandatory special reserves are not required? How would your attitude toward new lending, sale of loans in the secondary market, or debt concessions be affected by changes in reserve policy?

- A. 1. Our bank's objective has been to stay ahead of the reserving and charge off requirements of the regulators, both in terms of percentages where reserves are required and also the OTRP countries. If reserve policy were stricter we would have followed the same approach, namely write down, sell assets, or reserve more aggressively than required because of our assessment of the value of the underlying assets.

- Q. 2. At the hearing, we discussed alternative approaches to this capital question. I put forward the concept of raising new primary capital, as opposed to reserving against all OTRP loans, as a superior means of strengthening banks against risk. I also suggested that capital requirements should be established based on a basket of countries rather than on loan-by-loan review of all OTRP exposure. Finally, the capital requirement would apply to a subset of riskier OTRP countries that are not improving their capital position. Exposure to those OTRP countries improving their financial position would be treated as ultimately collectible and therefore deserving of more lenient regulatory treatment for debt-equity swaps and other measures to provide a "breather" on debt service.

Could you comment on these alternative approaches? In terms of capital position, would an equity or reserves approach be more likely to strengthen a bank's market position? Promote secondary market activity? Is a formula-driven, loan-by-loan reserve a more useful or disciplined mechanism, given the fungibility of money, than a broader mandate to build capital for a basket of country risk? Does differentiation of good and poor performers provide useful incentives to encourage banks and countries to cooperate, or does this not matter? Finally, is there need for a more "supportive regulatory structure" to encourage debt workouts, or is present regulatory management sufficient?

- A. 2. Primary capital increases support a wide range of bank activities and risks, while a basket reserve against all UTRP Loans clearly isolates the specific risk against which the reserve is intended. Even if the capital ratio specifically relates to the same basket of countries for which the reserve is intended, it seems to us the reserve is preferable. Risk based capital is not yet an accepted practice in regulating language while specific reserves are routine. On the other hand, whether a reserve or capital, a basket approach is far better than a loan by loan approach where judgements and condition change year by year, as do political relationships which can influence categorization. For this reason we also would be cautious about too many subsets of countries based on intentions and plans which can shift year to year. We can see its value in encouraging a country to cooperate, but does not change the fundamental risk to the lender or the system. The regulatory structure should be more supportive of flexible workout approaches and accounting conventions to limit negative interpretation which would result.
- Q. 3. Debt-equity swaps have been occurring to only a limited extent. In part this is due to the supply of attractive equity and partly to the unwillingness of governments to see it swapped with foreigners or as a means to repatriate capital. But where swaps have been aggressively pursued, as in Chile, it is possible to achieve conversion of considerable debt in a short period of time. Yet U.S. banks have participated to only a limited extent.

What has been your bank's approach to debt-equity conversions? Why have U.S. banks played only a limited role in this market? Is holding equity an attractive alternative to holding existing debt paper in these countries? Much is made of regulatory impediments to swaps, but are there specific regulatory and accounting problems facing you in your exploration of the swap market?

A. 3. We do not have relative statistics on US and foreign participations in the debt-equity market. However, given more aggressive write-downs among European banks of LDC debt, equity can be preferable to lower carrying values. Our own bank has not participated but would consider doing so in countries we consider of long term strategic value to the bank. Our concerns are two: First, under present regulations equity taken in exchange in distress situations is limited for long term retention, and second, equity swaps could reduce the saleability of the assets. The regulations also should support a liberal valuation of the equity taken in exchange, which will allow the most heavily exposed to avoid heavy write-downs.

Q. 4. Smaller banks and those with limited LDC exposure want to put the problem behind them and, as was noted at the hearing, would prefer interest concessions and modest write-downs to further involvement in financing.

Isn't this primarily a problem of agreement on mechanisms among creditor banks and debtor countries? Are there legal or regulatory impediments to solutions of this kind? Would eliminating many small debt-holders simplify the process? What is the down side of smaller banks withdrawing?

A. 4. The issue of smaller banks with lesser exposures is not solely a problem of mechanisms. It is also an issue of banking prudence which dictates that resolutions of problematic situations be addressed promptly even if it involves write-downs and reduced interest rates. After five years there is strong pressure to begin addressing the LDC in that fashion. While there is no legal or regulatory impediment to this, different banks carrying the same assets at widely diverging values raises accounting and regulatory issues. The withdrawal of small debt holders would vastly simplify the process, leaving the problem to those for whom it is a significant matter. The only problem is that, of course, future new money requirements will fall to those for whom the continuing flow of interest income is especially important.

- Q. 5. Value Impaired countries are those whose debt is being written off by banks. This appears to be a one-way street that drops these countries out of the financial system.

Are there any steps possible to "normalize" relations with these countries? Can they expect to restore access to trade finance even if their chances of restoring creditworthiness are small?

- A. 5. In our view the value impaired countries could restore their access to trade finance by a clear and specific subordination of all past debt to the servicing requirements of new trade debt. While this is not possible for all countries, it could help many.

FROM 1817

187.04.04 09:00

Description of Purposes for Amending Section 4(c) (13)
of the Bank Holding Company Act

The Bank Holding Company Act of 1956, as amended (12 U.S.C. §§1841 et seq.) (the "Act"), specifically recognizes the importance of debt/equity conversions by providing exceptions in Sections 2(a) (5) (D), 3(a) (5) (B) and 4(c) (2) (12 U.S.C. §§1841(a) (5) (D), 1842(a) (5) (B) and 1843(c) (2)), from the nonbanking prohibitions of the Act for securities acquired by the lender in satisfaction of a debt previously contracted in good faith ("dpc"). The proposed amendment applies this exception to accommodate the special situations created by foreign debt/equity conversions by amending Section 4(c) (13) of the Act (12 U.S.C. §1843(c) (13)) to provide U.S. lenders with an additional alternative in dealing with the external debt of many of the less developed countries that have already been determined by Congress in the 1986 Tax Reform Act as being entitled to special treatment. Section 4(c) (13) is the statutory provision specifically designated by Congress for bank holding company investments in foreign companies.

One of the most promising and creative responses to the current shortage of financial resources and excessive burden of external debt in many less developed countries ("LDC") is the conversion of debt into equity participations. This conversion process has the potential to reduce some of the concern and uncertainty over the possible impact of LDC debt on the international banking system. While only a limited number of the most heavily indebted countries, including Argentina, Brazil, Chile, Mexico and the Philippines, had adopted policies to allow such conversions by the end of 1986, other countries have since implemented similar measures.

The principles behind debt for equity conversions are not new and are both recognized in law and long followed in practice. For example, as part of insolvency proceedings creditors frequently receive equity securities of the debtor in whole or partial satisfaction of the debt obligation. Similar arrangements are frequently made in voluntary reorganizations. Likewise, banks frequently realize returns upon equity securities that have been pledged as collateral for a loan in satisfaction of the loan obligation. In many cases, these securities represent all of the common stock of a subsidiary of the debtor or of an unaffiliated company.

Although conversions have been commonplace in connection with domestic transactions, they have rarely been used in dealing with problem foreign loans. This can be traced to a variety of

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economic, legal and political factors. For example, in the case of sovereign loans, no collateral other than government guarantees is normally pledged. Now, however, with the LDC debt situation in a crisis condition, there is need for innovative solutions. Particular attention should be given to the possibility of adopting debt/equity conversions as one of the means for coping with international problem loans.

A number of U.S. banking organizations hold considerable amounts of debt owed by both the public and private sectors in LDCs. The ability of these LDCs to pay off this debt has been made difficult by declining commodity prices, falling oil prices, and general political and social conditions. In reaction, the commercial banks have made efforts to reduce their exposure by such means as loan trades and outright sales. The sale of bank assets in turn has led to the creation of a secondary market in LDC debt, where such paper usually sells at a discount from face value. In light of the magnitude of the problem, wherein the total external debt exposure of just the five above-referenced countries was projected at \$315 billion as of the end of 1986 (based on estimates of World Bank, IMF, BIS and country central bank data), these methods of dealing with credit quality deterioration, while still valid, are probably inadequate.

The process of conversion itself is rather straightforward. The investor converts a foreign exchange-denominated debt with the central bank for local currency at or near the paper's face (not discounted) value. The proceeds of the conversion are then applied to a government-approved investment. In each of the programs thus far in operation there are restrictions on dividend and capital repatriation. Only Chile's program is free from other important and costly restrictions. This conversion process applies to any investor, including commercial banks.

Once an equity investment is consummated, the commercial bank has the option to sell the investment to a buyer, who could be located outside the country of investment. Such a buyer may be a corporation interested in expanding its presence in the country or an entity seeking entrance into the country. Other potential purchasers are, of course, local private investors for local currency. Alternatively, the bank may elect to hold the investment and wait for repatriation as set forth under the debt/equity regulations. The choice between selling or holding would be based on the strategic objectives of the banking organization involved.

Conversion of debt to equity entails certain risks. First, an equity holder ranks below a debt holder in liquidation. Additionally, the banking organization will not only have to worry about the availability of foreign exchange (sovereign

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risk), but it will now have to concern itself with the various business risks associated with operating a company in a foreign country. The business risks can be managed, however, by the employment of skilled professionals and careful selection of the investments to be made.

In addition, the extent of debt/equity programs will be limited due to economic and political factors. Economically, capitalization of foreign debt can have the effect of increasing the money supply, unless the central bank is willing and able to neutralize the monetary effect of the transaction. The concern that excessive monetary growth resulting in inflationary pressures as an outcome of debt/equity conversions will serve to limit the growth of these programs. Moreover, political pressures against increasing foreign ownership will also exert a limiting influence, as will government restrictions on the areas of the economy in which foreign ownership is permitted.

However, Debt/equity programs offer benefits to all participants. Since loans to certain LDCs can be purchased at a discount from their face value, an investor can obtain local currency financing for investment purposes at a lower cost than if the funds were borrowed locally or if an equivalent amount of foreign currency were brought from abroad and exchanged at official rates. For domestic companies wishing to retire local currency debts, conversions may be a less expensive way to improve cash flows and ultimately raise a company's profitability. Furthermore, the value of a commercial bank's portfolio may be enhanced by exchanging financial assets for equity holdings in local companies. The exchange of debt for equity offers the possibility that dividends and the ultimate payout of the credit will occur in a less risky fashion than awaiting debt repayments. For the developing country with an excessive amount of external debt, engaging in conversions reduces the absolute level of its external debt and associated debt servicing burden.

By limiting the short run drain of foreign exchange reserves, the country's need for new money is commensurately diminished. For example, if only ten percent of the estimated end of 1986 commercial debt for the five referenced countries was converted into equity holdings over the next five years (conservatively assuming two percent per year), the accumulated savings on interest would amount to almost \$4.7 billion. If that conversion were accelerated to two years, the savings would rise to roughly \$8.6 billion over the same five-year period. For several of these countries, the ten percent figure is quite modest and the potential for savings could be even greater.

By reducing the debt-servicing burden on LDCs, the amount of new money will be reduced as well. In this manner, the

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country's creditworthiness will be increased as its debt servicing burden is lessened. This will have the effect of improving the portfolio of not only the investing bank, but other creditors holding the debt of the country in question. Consequently, debt/equity conversions benefit all of a country's foreign bank and nonbank creditors, not just the investing bank.

Besides the financial advantages, debt/equity conversions also result in real economic benefits for the host country. Conversions offer a vehicle for increasing investment in the economy, which could lead to all of the multiplier effects of any productive activity. Adoption of these programs, especially if in conjunction with other macroeconomic adjustment policies, can create an environment conducive to additional capital inflows from foreigners as well as from domestic investors who have sent money abroad. Creating the stimulus for repatriation of flight capital is a crucial element to any long-term solution to the debt crisis.

On balance, debt/equity conversion programs offer a market-oriented response to the debt problem facing many third world countries. The external benefits include improving the external accounts and cash flow of the debtor country through debt reduction and the subsequent lowering of interest payments. On the domestic side, debt/equity conversions can lead to increased investment, production, and employment levels. Although a debt/equity program can have adverse monetary effects if the central bank cannot or will not neutralize the monetary effects of the conversions, these effects can be managed; therefore, debt/equity programs are not inflationary per se. Furthermore, such programs can be used as a vehicle to repatriate flight capital and increase foreign capital inflows.

To reiterate, debt/equity programs have benefits for all parties involved. The debtor nation can enjoy the financial and real benefits of increased investment, employment, and creditworthiness. The creditor banks can enjoy an improvement in the quality of their portfolios through the sale of LDC assets, the investment made, and the enhanced economic potential of the debtor country. Investors can enjoy the benefits of the incentives offered by the debt/equity mechanism. Domestic companies enjoy increased capitalization and a strengthening of their balance sheets. The increasing use of such programs points out the growing recognition of debt/equity conversions as an important part of the solution to the LDC debt problem.

As indicated above, the Act specifically recognizes the importance of debt/equity conversions. These exceptions are directed, however, to domestic transactions and, as such, the

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maximum holding periods (two years plus up to three one-year extensions) are insufficient for foreign transactions. Because the financial difficulties of the LDC countries must necessarily be resolved over a long period, it is unlikely that a sale of a bank's equity investment can be accomplished within the currently established two years, and in many cases even five years would not be realistic. For those banking organizations that elect the repatriation alternative, five years will clearly be inadequate. In addition, in view of the complex nature of foreign debt/equity conversions, the transactions may not, in all cases, clearly qualify for the "dpc" exception.

The attached amendment to Section 4(c)(13) attempts to accommodate the special situations created by foreign debt/equity conversions. The proposed amendment would permit bank holding companies and/or their subsidiaries to make debt/equity conversions in certain countries already determined by Congress in the 1986 Tax Reform Act (see Section 1201(e)(2)(H) of Public Law 99-514) to be entitled to special treatment if the debt being converted has been renegotiated. As proposed, the equity interest may be held by bank holding companies and/or their banking subsidiaries for ten years or, if later in time, up to five years after the LDC country's law requires repatriation of the principal unless the Federal Reserve Board finds that the conversion of such interest would constitute an unsafe or unsound banking practice.

FROM 1813

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Sullivan →

Proposed Amendatory Language to Section 4(c) (13)
of the Bank Holding Company Act

It is proposed that the following underlined language be added to Section 4(c) (13) of the Bank Holding Company Act (12 U.S.C. §1843(c) (13)) so that it will read as follows:

(13) shares of, or activities conducted by, any company which does no business in the United States except as an incident to its international or foreign business, if (A) the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of this Act and would be in the public interest; or (B) the shares are acquired as a result of or in connection with a conversion or exchange of debt securities or loans, or any similar transaction, provided that (i) such loans or debt securities were made to or issued by a country specified in Section 1201(e) (2) (H) of Public Law 99-514, or any company or other entity located in such country, (ii) prior to effecting the acquisition of shares, the bank holding company has provided at least 15 days' written notice to the Board and the Board has not, within such period, notified the bank holding company that such a conversion would constitute an unsafe or unsound banking practice, and (iii) the shares are not held for more than ten years or, if later, five years after the investment may be legally repatriated in its entirety subject, however, to the Board's authority to extend such period for good cause.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
JACK GUENTHER

Question 1: Many countries' debt has been rated as impaired by regulators -- Other Transfer Risk Problems or below -- for some time, yet only a handful of hopelessly indebted countries have required reserves set aside under the International Lending Supervision Act. The regulators require no particular action by banks to increase capital as a result of this exposure.

What has been the reserve policy of your bank with regard to debt for which mandatory special reserves are not required? How would your attitude toward new lending, sale of loans in the secondary market, or debt concessions be affected by changes in reserve policy?

Answer 1: Standard bank accounting requires a bank to make its own judgments regarding loan writeoffs or the creation of reserves. This internal bank process sometimes produces specific writeoffs on countries beyond those mandated by the regulators. However, Citicorp has not taken large writeoffs in addition to those mandated.

In addition to these specific reserves to cover transfer problems, banks are required to maintain a "general loan loss reserve". This reserve, together with equity and other forms of capital, is available to meet future losses for whatever reason, i.e., transfer problems or credit problems. The regulators have, in fact, required banks which are heavily involved in overseas lending to build up their capital above the minimum levels. Citicorp's own additions to this general loan loss reserve and its growth in total capital have been particularly rapid in the past two years, in part reflecting larger transfer and credit risks in the rescheduling countries.

It is difficult to comment on how reserve policy changes would affect bank behavior without knowing the precise nature of the changes. On the assumption that the question refers to changes in mandated reserve policy, the key question would be whether the changes paralleled the bank's own internal assessment of the evolving risks, or alternatively, reflected an increasing injection of political consideration into this area of international lending. Provided the changes involved primarily prudential considerations similar to those which banks themselves make, the changes would be unlikely to have a major effect on attitudes toward debt concessions, new lending or sales of loans in the secondary market. If, on the other hand, the mandated changes were perceived to be part of an effort to require banks to finance a concessionary assistance program for developing countries or expressed considerable alarm about the future of the international economy, the effect would be to discourage lending. In summary, we would find it very difficult to make new loans to

countries for which we had just taken a specific reserve.

Question 2: At the hearing, we discussed alternative approaches to this capital question. I put forward the concept of raising new primary capital, as opposed to reserving against all OTRP loans, as a superior means of strengthening banks against risk. I also suggested that capital requirements should be established based on a basket of countries rather than on loan-by-loan review of all OTRP exposure. Finally, the capital requirement would apply to a subset of riskier OTRP countries that are not improving their capital position. Exposure to those OTRP countries improving their financial position would be treated as ultimately collectible and therefore deserving of more lenient regulatory treatment for debt-equity swaps and other measures to provide a "breather" on debt service.

Could you comment on these alternative approaches? In terms of capital position, would an equity or reserves approach be more likely to strengthen a bank's market position? Promote secondary market activity? Is a formula-driven, loan-by-loan reserve a more useful or disciplined mechanism, given the fungibility of money, than a broader mandate to build capital for a basket of country risk? Does differentiation of good and poor performers provide useful incentives to encourage banks and countries to cooperate, or does this not matter? Finally, is there need for a more "supportive regulatory structure" to encourage debt workouts, or is present regulatory management sufficient?

Answer 2: In those dozen or so countries which have exhibited severe and protracted problems in servicing loans, specific writeoffs or the creation of specific reserves are warranted and are consistent with standard bank accounting practice. On the other hand, where general potential problems are perceived to exist, but individual countries currently are making strong and largely successful effort to service obligations on time, general purpose additions to reserves and other forms of capital are more appropriate than rather arbitrary country-by-country or loan-by-loan writeoffs.

The regulatory structure already is properly "supportive" of debt workouts, and no change seems to be necessary, except a change in Reg. K to facilitate U.S. bank conversion of debt to equity, which is discussed below.

Question 3: Debt-equity swaps have been occurring to only a limited extent. In part this is due to the supply of attractive equity and partly to the unwillingness of governments to see it swapped with foreigners or as a means to repatriate capital. But where swaps have been aggressively pursued, as in Chile, it is

possible to achieve conversion of considerable debt in a short period of time. Yet U.S. banks have participated to only a limited extent.

What has been your bank's approach to debt-equity conversions? Why have U.S. banks played only a limited role in this market? Is holding equity an attractive alternative to holding existing debt paper in these countries? Much is made of regulatory impediments to swaps, but are there specific regulatory and accounting problems facing you in your exploration of the swap market?

Answer 3: All the heavily-indebted countries would benefit from a higher proportion of equity investment. My bank is prepared to convert a portion of its own debt into equity, and also actively assist manufacturing firms to increase their own equity investments through debt-equity conversions. To date, the bank itself has converted debt to equity in 3 countries, in order to build up its capital in branches or financial subsidiaries.

One reason for the slow pace of debt-equity conversions has been the ambivalence of the debtor countries themselves. In addition, U.S. banks are inhibited by specific regulatory limits. Under existing rules, there are several obstacles to U.S. banking institutions taking advantage of debt-equity conversion opportunities in developing countries. These primarily are: The regulatory limits on the percentage ownership permitted bank holding companies and Edge corporations in shares of companies that are not engaged solely in banking or financial activities (i.e., the 20% ownership limitation in Reg. K), as well as the Reg. K requirement for prior Federal Reserve approval of investments which exceed \$15 million. These two aspects of Reg. K, which were not designed or adopted with reference to the debt-equity conversion programs in the context of the present international debt problem, raise some obvious practical problems.

First, most Third World local equity investment opportunities today arise in the non-banking sectors of the applicable countries. Second, a controlling interest in a company may well be a safer investment than a passive investment where trained management is in short supply. Third, the most attractive opportunities for such investment are likely to be in larger companies, where investment in excess of \$15 million will be appropriate. Indeed, given the likelihood that there are a limited number of attractive investment opportunities in any single country, the \$15 million limitation per investment is inappropriately restrictive. Fourth, an ability to act quickly can be important to a U.S. banking institution's obtaining the local government's permission to invest under a debt-equity conversion program and being able to compete with other investors in that market to obtain a fair and equitable price on the

transaction.

Regarding the accounting treatment, there are two existing accounting concepts that are important and should be retained. First, it is important that when a bank decides to sell or swap a portion of its existing portfolio of loans to a country, the remaining loans do not have to be marked to market. And second, it is important that when a bank swaps its debt into equity in a developing country, it need not necessarily write down that debt to the price of such debt in the secondary market. That market for LDC debt is extraordinarily thin, and market prices in such a situation are not necessarily representative.

In order to help facilitate debt-equity swaps, it would be helpful to confirm that no loss need be recorded by a bank when the value of the equity received in a swap, converted to dollars at the current exchange rate, is at least equal to the carrying value of the debt given up. While the same country risk considerations may apply to the bank's newly-acquired equity investment as formerly applied to its loan asset, the bank would have received full value in local currency terms in the transaction. Losses should only be recorded to the extent there is a shortfall in the value received.

Question 4: Small banks and those with limited LDC exposure want to put the problem behind them and, as was noted at the hearing, would prefer interest concessions and modest writedowns to further involvement in financing.

Isn't this primarily a problem of agreement on mechanisms among creditor banks and debtor countries? Are there legal or regulatory impediments to solutions of this kind? Would eliminating many small debt-holders simplify the process? What is the down side of smaller banks withdrawing?

Answer 4: I agree with your assessment that some banks (not necessarily very small) would prefer to make interest rate concessions and incur modest writedowns as an alternative to further involvement in financing LDC's.

As you suggest, this subject is on the agenda of most discussions between creditor banks and debtor countries. I see no legal impediments; and having to deal with a smaller number of banks clearly would facilitate future negotiations.

The downside of bank exits is the shrinkage of future financing available to the developing countries.

An example of how this exit provision for small banks might work is contained in the recent Alternative Participation

Instrument (API) proposed by Argentina. Banks providing new money to Argentina are asked to make a new money contribution during the next 12 months equivalent to 9% of their outstanding loans, at an interest rate of 7/8 of 1% over LIBOR. Alternatively, a bank may opt to "contribute" by converting up to \$5 million of its present stock of loans into the API. This is a 25-year claim paying a fixed interest rate of 3%, which would be exempt from future new money claims. On the assumption that LIBOR averages 7-1/8% (plus 7/8% spread) in the future, banks accepting the API would be providing annual interest rate relief to Argentina of 5% on the affected debt. During the next 12 months this "relief" or "balance of payments assistance" is less than the 9% of debt that would be provided by a new money contribution. Nevertheless, the 5% assistance through the API would be ongoing without the need for annual participations in new money packages. It is not known how many banks will opt for this alternative to the new money contribution.

Question 5: Value impaired countries are those whose debt is being written off by banks. This appears to be a one-way street that drops these countries out of the financial system.

Are there any steps possible to "normalize" relations with these countries? Can they expect to restore access to trade finance even if their chances of restoring creditworthiness are small?

Answer 5: The regulators have the flexibility to classify some types of loans to a country as value impaired while classifying trade credits to the country in a higher category, such as substandard. In fact, there are several examples where this has been done, in recognition of the fact that the country has maintained service payments on its trade credits while falling behind in interest and amortization on other types of loans. In other cases, however, where the debt-service performance has been equally poor on all types of claims, the regulators have little choice but to regard all the claims on the country as value impaired. Regardless of the regulatory action, banks make their own judgments as to the risk of doing trade credits in situations where the country is failing to service other loans. In some cases a modest amount of trade credits are continued. Of course, where bank financing is not available, manufacturing firms have the option of financing their own trade sales. Trade financing from manufacturers was the predominant form of trade finance in the 1950's and 1960's and has continued to play some role. However, the risk considerations for the manufacturer are roughly similar to those facing banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
KARIN LISSACKES

Following my testimony before the Committee on April 2, I was asked to respond to a question from Senator Heinz regarding the Japanese bank debt-factoring facility.

My understanding (based on published accounts and conversations with U.S. and Japanese bankers) is that a group of Japanese banks with troubled LDC loans in their portfolios are establishing a joint factoring company in the Cayman Islands to purchase such loans at a discount and to assume responsibility for collection or disposal of the loans. Participating banks will pay in capital to finance the factoring company--probably in relation to the amount of loans they transfer to the company. Initial capitalization is reported to be quite small, about \$84,000.

Banks will sell loans at a discount to the factoring company and in return receive shares in the company matching the discounted value of the loans sold. If for example, Bank of Tokyo sells \$100 million of its Brazil portfolio to the Cayman facility at a 30% discount, it will receive as payment shares in the facility valued at \$70 million. If and when the factoring facility receives interest payments from Brazil, or sells the loans to a third party, Bank of Tokyo will receive dividends on its shares reflecting the factoring company's income.

From an accounting standpoint, what Bank of Tokyo has done is to write down its Brazil asset from \$100 million to \$70 million. (The asset is now in the form of a claim on the factoring company rather than a direct claim on Brazil). The Japanese bank will cover the loss entailed in this 30% devaluation of its Brazil asset by writing up undervalued shares in Japanese corporations which the bank has been carrying on its books at the original acquisition value. (Japanese commercial banks own about 15% of the current market value of the Tokyo stock exchange and much of this is carried well below current market price.)

Apparently only a bookkeeping procedure is needed to effectuate the stock revaluation. That is, Japanese banks can keep the securities, but now carry them on the books at a new value, reflecting current market prices. By contrast, U.S. banks which carry undervalued assets on their books must actually sell them (as Bank of America has done) to "realize" the gain.

Both the loan write-down and the securities write-up apparently have tax implications for the Japanese banks. The write down will produce a tax-deductible loss and the security revaluation will produce a taxable income gain. My understanding is that these transactions will be structured so the tax loss will exactly off-set the tax gain and the whole transaction is tax revenue neutral--something the Ministry of Finance reportedly insisted on.

is this sleight-of-hand, as Senator Heinz asks? On the contrary, one can argue that the net result is more honest bookkeeping: at least some previously overvalued Latin American loans and undervalued Japanese corporate securities will be carried on the books of participating banks at closer to real market value. Far preferable to the current bookkeeping fiction that loans to Brazil, Argentina, the Philippines and the rest are still worth 100 cents on the dollar.

What would be the the cost to banks and taxpayers of a similar move by U.S. banks? The cost to U.S. banks of a writedown of LDC loans would be the same as for Japanese banks: they would have to take the losses, either through reduced earnings, or the sale securities or other assets. The real difference, as already noted, is that U.S. banks would be required to sell undervalued assets to realize the gain that would offset the loan write-down, if that is the route they choose. And of course U.S. banks have never been permitted to accumulate the sort of "hidden reserves" that are common in Europe, Japan and Hong Kong.

The cost to the U.S. Treasury would probably be insignificant for the simple reason that U.S. banks, and particularly the big multinational banks which account for most of the lending to Third World countries, pay almost no U.S. corporate income tax -- and probably won't even under the new tax reform law. The generous provisions regarding foreign tax credits which in the past have enable the big banks to wipe out large chunks of their U.S. tax obligations have been retained for loans to 34 troubled debtor countries (and these are the countries that give rise to virtually all the foreign tax credits claimed by the large banks). It is also noteworthy that foreign tax credits are the only credit that will be allowed against the Alternative Minimum Tax, in 1992.

The real obstacle to a more realistic valuation of U.S. banks' troubled LDC loans is not the tax question but the current debt strategy. Treasury is understandably reluctant to press banks to show the impaired value of their LDC loans while it is also asking the banks to commit more funds to these same countries. We won't get more realistic bank bookkeeping until we get a more realistic debt policy.

There is some indication that the U.S. Treasury and the Federal Reserve are less than enthusiastic about the Japanese bank initiative and that in response, Japan's Ministry of Finance is discouraging Japanese banks from making as extensive use of their new factoring facility as they would like. The Committee might want to inquire further?

Karin Lissakers

Adjunct Professor
Columbia University School of
International and Public Affairs

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
ALLAN MENDELOWITZ

1. You noted bank concerns that reserves and write-downs would damage market perceptions of their financial strength, raising capital costs, etc. You also noted tax disincentives. Do these points argue for building strength against future losses by raising equity capital (risk-based capital approach) instead of building reserves?

We endorse building bank capital as one way in which U.S. banks can strengthen their financial statements against the LDC debt problem. However, this approach alone is not sufficient to deal with the debt crisis. The building of LDC debt reserves is a more direct way to present more realistic financial statements which are important if banks are to be able to recognize future loan losses. Such losses are written-down against reserves, not against capital, under generally accepted accounting principles (GAAP) and bank regulations. If they are not required to build up reserves to absorb such writedowns, banks continue to have an incentive not to recognize declines in the value of their LDC loans. Thus, a buildup of bank capital alone avoids the need for change in banks' response to the LDC debt problem.

Additionally, if higher capital were required instead of higher reserves, shareholders, policy makers and regulators would not be able to clearly see the extent of the LDC problem on banks' books. Currently, banks are required under GAAP to show the impairment in their overall loan portfolio by netting out the reserve for loan losses on their balance sheet. As we recommended in our testimony, financial statement standards should require banks to present their LDC debt reserves separately. Finally, we note that substituting capital growth alone for loan loss reserve buildups would enable banks to avoid providing for their loan loss reserves from current income. This is contrary to a fundamental accounting principle that the recognition of loan losses and possible loan losses be made in the period in which loans are determined to be impaired.

2. You mention the benefit of more reserves on more loans as a useful step. You note secondary-market values and special reserve authorities under HSA as possible mechanisms. Are ATRNs under HSA, which have been little used, viewed as onerous by the banks and regulators?

If ATRNS were used to the extent we believe would have been appropriate to reflect actual impairment in loan portfolios, it is our understanding that banks and regulators would have considered

them to be onerous. AIRRS are categorized as special reserves and, as such, would not be included in the regulatory calculation of primary capital. While we realize the difficulties faced by banks in establishing large reserves against LDC debt, we feel the need for accurate reporting is paramount.

3. I share your view that capital should be increased to indemnify banks against risk for "a larger number of countries" than at present. I have problems, however, with reserving against all classified countries as providing disincentives to countries and banks to work out their problems. I believe criteria should differentiate good performers from those with increasing risk of non-payment. Where would you draw the line? How might regulators differentiate countries?

We believe that it is difficult for regulators to objectively create categories that differentiate good performers from those with increasing risk of non-payment. Such decisions could possibly lead to the alienation of those countries not granted favored treatment, compounding existing debt servicing problems. A more desirable approach would be provided by using the secondary market for LDC as a primary consideration in determining the level of appropriate reserves. The secondary market implicitly differentiates LDCs into relatively low risk and riskier performers through its pricing mechanism. Debt owed by countries with relatively significant current or expected payment difficulties will be lower priced on the market, while those countries who have been able to service their debt will have higher priced debt.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM
ROBERT R. BENCH

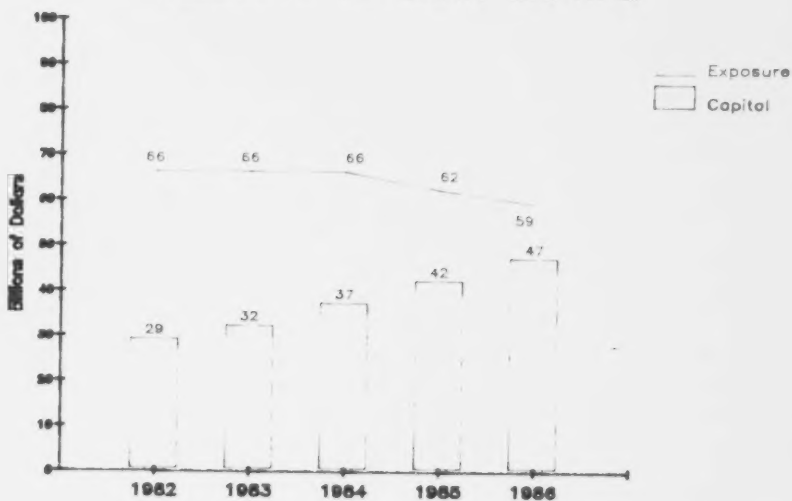
Question 1

As in last year's testimony, you noted the progress made in strengthening bank capital. While it is clear that the capital position of banks continues to improve, can a correlation be shown between the differential exposure of banks to LDC risk and their capital positions?

Answer

There continues to be a positive correlation between growth in bank capital and the banks' exposures to LDC debt. The following graphs show this correlation well.

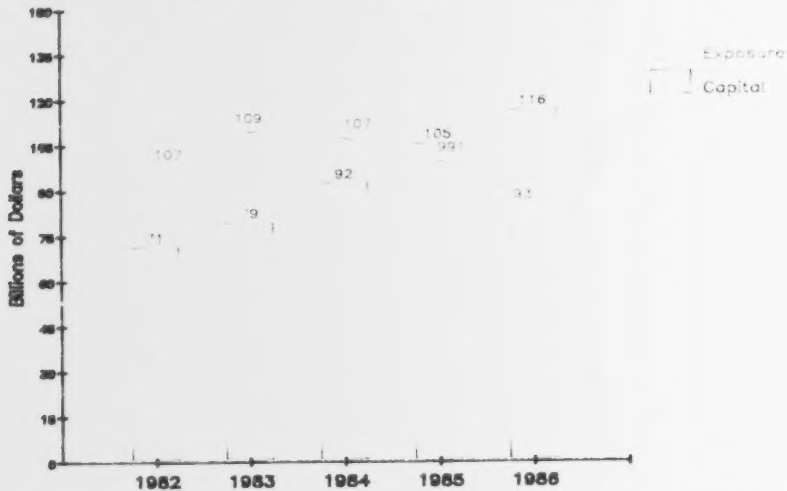
**NINE MONEY CENTER BANK EXPOSURE
TO DEVELOPING COUNTRIES
RELATIVE TO BANK CAPITAL**



Source: FFED

U.S. BANK EXPOSURE

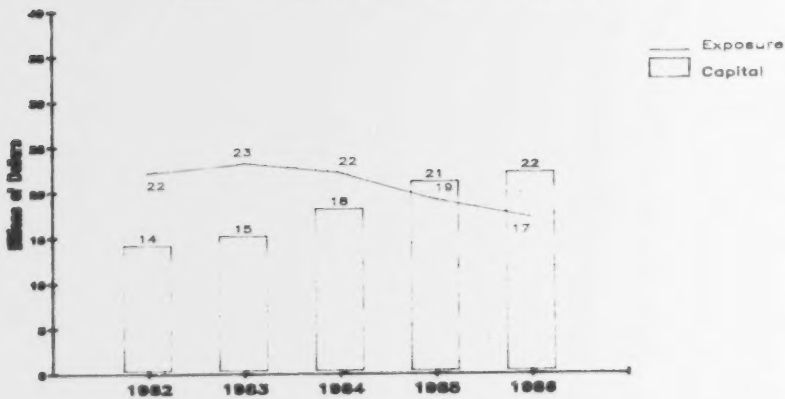
TO DEVELOPING COUNTRIES
RELATIVE TO BANK CAPITAL



Source: FFIEC

14 OTHER LARGE BANK EXPOSURE

TO DEVELOPING COUNTRIES
RELATIVE TO BANK CAPITAL



Source: FFIEC

Question 2

ATRRs under ILSA have been applied to only a handful of countries, yet a large number of countries are classified as OTRP or below from year to year. At the Committee's debt hearings, I argued that capital should be increased to reflect these risks and promote efforts by banks to better manage this risk. Is increasing bank capital to reflect risks arising from these classified loans useful? Is increasing equity preferable to building reserves as a means to strengthen banks? Is a formula-driven, loan-by loan reserve system as has been proposed preferable to, or ultimately more disciplined than, a broader mandate for increased capital to regulators based on risk arising from a basket of countries?

Answer

Throughout the international debt problem, the policies of this Office have been to encourage banks to steadily and deliberately increase their capital, including reserves, to underpin their existing assets categorized as OTRP as well as any modest increases in new lending. By emphasizing capital, we provide banks with flexibility as to the degree of underpinning they may wish to do through increases in equity, dividend pay-outs, provisioning to loan loss reserves, or any combination thereof. We have preferred this broader approach because it more appropriately deals with the basket of latent and shifting transfer risks being supervised.

Question 3

I believe that the present OTRP category does not sufficiently differentiate risks of good vs. poor performing countries nor does it require any specific action by banks to protect against LDC risk. I believe there should be greater differentiation, with capital requirements focused on the risk arising from poor performers. Would basing capital requirements on such a bifurcated approach be more or less useful than an across the board reserve requirement for all debtors? Would it likely serve as an incentive to prod debtors and banks to develop workable recovery programs, or is it likely to have limited effect in this area?

Answer

OTRP is intended to be a broad category which reflects the basket of changing risks previously mentioned. Our criteria were detailed on page 5 of my testimony. We vary the coverage of the category depending on the nature of certain assets as well as our view about performance. Therefore, the degree to which we see performance vis-a-vis the criteria determines the amounts of assets we subject to the category of OTRP. In addition, poorer performance outside the criteria of OTRP is classified either Substandard or Value Impaired.

We do expect banks to take action against assets categorized as OTRP and as a general rule, all U.S. banks have formally factored OTRP assets into their capital and reserving policies. Therefore, I believe the present practices of the banks satisfy your concern, including serving as an incentive to achieve workable debt negotiations. However, a too direct, inflexible approach could create incentives not to participate in new lending to debtor countries, which would be contrary to the need of these countries for on-going flows of external capital to support structural reform and assist in economic growth.

Question 4

Also in the area of incentives, I have suggested an approach in which good performers would be accorded "supportive regulatory treatment" based on "ultimate collectibility" of their debt to broaden the menu of debt-workout mechanisms. In your testimony, you noted that "it may be time for the commercial banks to consider a blend of financing alternatives" and saw no regulatory impediments to most of the available alternatives (debt-equity, interest concessions). While mandating such solutions would not be useful, do you see any benefit in providing the kind of general guidance I have sketched out? Would such language ease the process of making difficult valuation judgements, or dealing with limits under Reg K and BHCA related to minority and time-limited holdings, etc?

Answer

It would be useful to reach some general agreement in this area. Chairman Volcker indicated in his recent testimony before the Committee that the Board was reviewing their position as to accommodating alternatives under Reg K and the BHCA. While an expression of support for that review would no doubt be welcome, I would caution against legislation which prejudged the conclusions of that review.

Question 5

One approach on the table would expand Section 4(c)(13) of the BHCA to permit banks to take substantial capital positions in companies whose shares were obtained through debt-equity swaps and to hold them for periods of ten years or more, subject of course to Federal Reserve review. Would such treatment open up many more deals to banks that they do not consider now? Would it represent a new and different approach to separation of banking and commerce than is now contemplated in law?

Answer

The pace and degree to which U.S. banks can take and hold equities in non-financial firms to accommodate debt-equity swaps and assist in reducing debt service burdens of debtor countries requires careful consideration. Experience so far seems to suggest that the present regulatory framework does not impede these transactions. The constraint on prudent transactions is limited now by the policies in the debtor countries. Permitting an expansion of 4(c)(13) of the BHCA would represent a new and divergent approach to the traditional policy of separating banking and commerce. As I indicated previously, it may be better to see the conclusions of the present review of this matter by the Federal Reserve before changing policy for these transactions.

Question 6

Chile is an example of a country swapping substantial debt for equity, with significant impact on debt-service requirements. Yet much is made of the fact that swaps cannot have much impact. Why is Chile different? Is it not a useful example of what countries can do if so inclined to reduce debt and promote equity investment?

Answer

The degree of impact debt-equity swaps may have on a particular country is a function of the policies within the country. Chile, for example, has two swap programs designed to promote the repatriation of capital and to stimulate foreign investment (the former is substantially larger than the latter). Although Chile closely monitors and controls the volume of swaps, it has opened its economy to them, and manages its swap programs within a hospitable economic policy. Other countries have yet to establish basic policies as hospitable as Chile's. Some countries have yet to institute controlled monetary policies. Other countries have confined the sectors into which swaps may be done. Many countries still impose so many conditions on swaps that the investments do not match the portfolio preferences of potential investing banks. Overall, however, we see more countries endeavoring to implement the right policies and the result should be a greater impact for debt-equity swaps in countries other than Chile.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
PAUL A. VOLCKER

Question 1: It is widely agreed that the United States, Japan, and West Germany must make important adjustments in their macroeconomic policies. The changes we must make include reducing our deficits and reorienting our domestic spending from consumption purposes to investment purposes. The changes the Japanese and West Germans must make are complementary to this--they must adopt more expansionary fiscal policies and promote domestic consumption as they reorient their economies away from such heavy reliance on exports.

The effort will require cooperation and sacrifice by the leaders and citizens of all three nations. This commitment can be assured in three democracies only if there is widespread understanding of who must do what and whether what needs to be done is getting done.

When you appeared before the Senate Banking Committee last time, it was for the monetary policy hearings. You were asked what GNP growth rates Japan and West Germany must attain for the system to, so to speak, balance out. You did not provide a clear answer. Let me ask you now, in specific GNP, fiscal and monetary policy terms, what must we do, and what must the Japanese and West Germans do for our economies to attain mutually beneficial growth patterns?

Answer: Achievement of satisfactory economic performance and improved external balance across the major industrial countries requires mutually supportive macroeconomic adjustments within the United States, Japan, and West Germany. In the United States, productive resources need to be redirected from domestic uses toward satisfying demand as well as replacing supply from abroad. In Japan and West Germany, as the strength of demand from abroad diminishes, domestic use of resources needs to expand in order to encourage the redirection of productive capacity.

The movements we have experienced to date in exchange rates have produced a change in the competitiveness of U.S. goods, especially relative to those of Japan and Germany, that I believe will lead over time to needed adjustment in production and demand here and abroad. Constructive monetary and fiscal policy steps in the United States, Japan, and Germany should be implemented to complement this process, however. In order to do this at rates of GNP growth consistent with the economic potential of these three countries, further reduction in the federal budget deficit in the United States is needed in order to free resources from domestic uses; fiscal and monetary policies in Japan and Germany need to be sufficient at least to offset lost external demand.

I cannot provide you with specific numbers. Many different combinations of policies within each country and across the major industrial countries can give rise to similar macroeconomic developments. The impact of policy actions in any one of these countries depends on the policy actions taken elsewhere. The fundamental point is that the needed reduction of external imbalances in the United States, Japan, and Germany requires that in the United States a positive gap be maintained for some time between the growth of GNP and of the total of domestic uses of output. Conversely, in both Japan and Germany, it is necessary that growth of domestically generated demand for

output remains above that of GNP. What is more important than the precise growth rates here and abroad is that there be a clear sense that a sustained and sustainable process of adjustment has been put in motion.

Question 2: No mention was made in your statement of one aspect of the LDC debt problem that may be very important--the development of deep and active capital markets in the debtor nations. The presence of such markets would do much to stabilize their monetary and fiscal policies by developing within each country a broad cadre of bond and equity investors who would be very sensitive to unwise policies and react quickly to correct them. The existence of such markets would do much to repatriate flight capital and attract new capital from around the world. A solid equity market would also do much to facilitate debt-equity swaps, in my judgment. Do you agree? What is being done and what can be done to further encourage the development of sound capital markets in the major debtor nations?

Answer: Broadly, I would agree that development of deep and active capital markets could help encourage more disciplined economic policies, more "transparency," and greater competition. Certainly an active equity market would, other things equal, make debt-equity swaps easier. Moreover, in appropriate conditions, development of deep and active capital markets in debtor nations over time could help to attract significant inflows of foreign financing, providing some alternative to foreign bank credits as a source of external credit.

However, I must also emphasize progress is likely to be slow relative to immediate needs and the potential validity of free and open capital markets in countries struggling to achieve confidence in difficult circumstances is not an unmixed blessing.

Increases in the stock of publicly traded, privately issued securities in developing countries would be a beneficial

process in most countries. The rate of progress is dependent on such things as the evolution of investor protections, financial reporting standards and laws, income tax and exchange laws conducive to accurate corporate accounting, and more fundamentally basic attitudes toward private property. Moreover, the uncertainties in recent years in some countries generated by international debt difficulties, government takeovers of financially weakened private enterprises, and volatile inflation unfortunately may have set back earlier progress toward development of deep and active capital markets in these countries.

Against that background, there appears recently to have been an atmosphere of recovery of confidence in economic policies of a number of debtor countries. It is interesting that, for example, Mexico has enjoyed both a recovery of its stock market and a reversal of capital flight since 1985, but--in that example as in others--it is difficult to judge or trace whether these were causally related events or subject to the common, determining influence of other factors.

Looking at the broader issue of how to improve the allocation of financial resources and real investments throughout the economy, the opportunities to improve the allocation of local bank credit often may be quantitatively more significant than the opportunities provided through further development of equity and bond markets. Thus, the search for efficient growth

in a number of debtor countries may be well served by reform in policies of interest rate subsidization and of non-price allocation of credit within their regulated or government-owned banking systems. The World Bank is active in advising and helping to finance a number of major debtor countries in this area of structural reform, and its affiliate, the International Finance Corporation, has been active in promoting the development of capital markets more broadly.

Question 3: There has clearly been a substantial downward adjustment of the dollar relative to the yen and mark, but very little adjustment relative to the currencies of other Pacific basin nations, generally referred to as the "newly industrialized countries"--the "NICs". What is happening with regard to these exchange rates and how can we get these nations into the broader discussions underway on economic coordination among the exporting nations?

Answer: The United States Government has been actively negotiating over trade issues and exchange rates with Pacific Basin nations, especially South Korea and Taiwan, the countries in that group with the largest trade and current account surpluses. Since February 1985, the New Taiwan (NT) dollar has appreciated against the U.S. dollar 13.5 percent, with more than a third of that occurring in the last four months. Although the Korean won has depreciated 0.8 percent against the dollar since February 1985, it has been appreciating since the beginning of 1986. In recent weeks the appreciation of the won and the NT dollar against the U.S. dollar has accelerated. Of course, it should be recalled that the dollar did not appreciate nearly as much against the currencies of the Pacific Basin's NICs in 1981-1984 as it had against the G-10 countries. In addition, it is only very recently that these countries, with the exception of Taiwan, have had significant current account surpluses.

While the U.S. Government has had extensive bilateral discussions with these countries on trade issues, particularly access to their domestic markets, it is also important that approaches to these countries be multilateral and that their trade and other economic policies be subjected to scrutiny in various international fora, such as the GATT and the IMF.

Question 4: On page 21 of your testimony, you state that "initiatives are underway among U.S. regional banks, looking toward the development of innovative approaches to broaden the choices of banks in structuring their participation in new financing programs." Could you tell us more about these initiatives? Do any of them deal with granting debt relief rather than putting in new loans?

Answer: Most banks that have participated in international lending recognize that the banking community has a responsibility--shared with other creditors--to provide financial support to heavily indebted countries when those countries are implementing appropriate macroeconomic and structural adjustment and growth policies. However, the particular circumstances and long-term strategic interests of individual banks differ. The objective of the initiatives I referred to is to find a way to accommodate the particular legitimate interests of individual banks within the context of a continuing need for new financing programs. The objective of these initiatives is not to provide general debt relief, but the effect in some instances could reduce debt burdens at the margin.

I would expect that the specific features of each financing package will vary in the future, as they have in the past. But it seems to me likely that future packages will contain some kind of "exit instrument", which will enable banks who no longer want to participate in new lending to a particular borrower to find an equitable way (possibly including acceptance of a lower interest rate) of meeting its longer-term responsibilities without burdening other creditors. Innovative

financing instruments could enhance the liquidity and marketability of a bank's claims and may be attractive to some banks. The financing package for Argentina that was recently agreed upon includes both features. Debt equity swaps and various "on lending" arrangements are possible, but perhaps more relevant for those with larger exposure. Methods of cooperation in lending with the World Bank have been explored.

Question 5: Last week, Mr. John Guenther, a senior vice president at Citibank, told us that it is a myth "that commercial banks have stopped providing any net new capital to the heavily indebted countries The banks continue to lend new funds and the debtors are not exporting capital." In contrast, you state on page 19 of your testimony that "available data suggest net new commercial lending virtually ceased in 1985 and 1986" Am I safe in assuming that you disagree with Citibank on that point? Do you agree or disagree that the debtor nations are now net capital exporters?

Answer: Since 1982, commercial banks have, indeed, participated in concerted new money packages totaling more than \$40 billion for the heavily indebted countries, the so-called Baker-15 countries. Nevertheless, the standard overall measure of net new bank credit, which is estimated from the total of international banks' outstanding claims on various dates, does suggest the total of net new commercial bank lending did virtually cease in 1985 and 1986. It is important to note that the bank data have been affected by transfer of claims to other creditors, including loan assumptions by export credit or other guaranteeing agencies and outright loan sales to nonbank creditors. Purchases by nonbanks have occurred in connection with various countries' debt-for-equity and debt-conversion programs. But even when these technical factors are taken into account, the response of commercial banks to the approach outlined by Secretary Baker has been limited. Certainly, continued net lending by private commercial banks is an essential part of a cooperative effort to implement the debt strategy, and finalization of the large Mexican lending package and the recently concluded Argentine negotiations may signal renewed impetus.

While net bank lending to heavily indebted countries has been disappointing in recent years, this does not mean that these countries have become net capital exporters. I think the discussion and understanding of this issue often are complicated by some of the terms used. Some people associate the net flow of real resources to a country with its trade balance. As we have seen, many of the major borrowing countries have been running substantial trade surpluses for some time, as they were before 1982. This does not mean that they are capital exporters as long as they are running current account deficits. The current account includes not just imports and exports of merchandise but also trade in services and interest payments. Despite what some commentators might say, interest payments for the present use by an economy of past capital inflows is as much an import as are machinery, wheat, oil, or tourism. This proposition holds regardless of the use that was made of those funds and regardless of the terms of the borrowing; it is a matter of economic accounting. As a group, the heavily indebted countries are running small current account deficits--about \$10 billion in 1986.

Question 6: Senator Bradley has proposed authorizing Treasury to determine on a year to year and country by country basis what portion of debt service payments certain indebted developing countries can afford to pay without receiving emergency credits and without sacrificing reasonable growth goals. Treasury would make such determinations only for debtor countries submitting growth plans. Senator Bradley has suggested that, on the basis of these determinations, the Treasury make recommendations to U.S. bank regulators that they allow banks to accrue to income no more debt service payments from eligible countries in a given year than Treasury has determined they can afford to pay. Banks would record payments in excess of such levels as additions to loan loss reserves.

I would like your opinion on this proposal and, in particular, your evaluation of its likely impact on:

- (1) the ability of bank income statements to reflect accurately improvements in bank cash flow and in the underlying value of their loan portfolios;
- (2) the future ability of banks to absorb Third World loan losses; and
- (3) the willingness of banks to make new loans to indebted developing countries for investment purposes (that is, to make loans apart from those needed to facilitate debt service payments).

Answer: Senator Bradley's proposal to authorize the U.S. Treasury to determine an acceptable level of debt service for each heavily indebted country and then to recommend that bank regulators require banks to commit payments in excess of that amount to increases in reserves might not have the intended effect on the behavior of U.S. banks, and it could undermine the willingness of debtor countries to implement desirable policy reforms.

The accounting profession and U.S. regulatory agencies have developed standards for financial accounting for banks over

many years. The continuity for those standards greatly facilitates investors' ability to evaluate accurately the financial condition of U.S. banks. The determinations by the Treasury of an appropriate level of debt service will be difficult at best. Requiring that these determinations be indirectly reflected on banks' income statements may undermine the clarity and quality of information available to the public on the financial condition of U.S. banks.

It is not clear that this proposal will affect the level of total loan loss reserves that banks would be likely to hold. Banks may choose to offset the additions to loan loss reserves required under the proposal by limiting additions to reserves from other sources. Thus, it is not obvious that this proposal will enhance banks' ability to absorb possible future losses on loans to developing countries.

Debtor countries might treat public statements by the U.S. Government regarding the appropriate level of debt service for heavily indebted countries as points of departure in negotiations between debtor countries and their private creditors. Political pressures within debtor countries may force government officials to demand concessional treatment that is at least as favorable as the Treasury determinations, even if they had been willing to accept market terms in order to protect their future creditworthiness. Under these circumstances, public statements by the U.S. Treasury on an appropriate level of debt service may

prejudice negotiations between debtor countries and their private creditors in a way that is detrimental to both parties. Consequently, the adoption of this proposal would tend to reduce the willingness of banks to extend new loans to heavily indebted and not so heavily indebted countries, because banks will expect debtor countries to demand more concessional terms in actual or potential future debt restructuring negotiations.



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U.S. BANK EXPOSURE IN THE "BAKER PLAN" FIFTEEN COUNTRIES

This brief report provides basic data on the exposure of U.S. banks in the fifteen developing countries which are part of the "Baker Plan." The tables which this report contains indicate total exposure in these countries, the shares of debt owed by public and private sectors, and the level of exposure to the nine largest U.S. banks and to all other U.S. banks.

by
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April 3, 1987

U.S. BANK EXPOSURE IN THE "BAKER PLAN" FIFTEEN COUNTRIES

This report provides data on the exposure of U.S. banks to the fifteen countries which are part of the "Baker Plan." The "Baker Plan" was announced at the Annual Meeting of the International Monetary Fund (IMF) and the World Bank in Seoul, Korea on October 8, 1985 by Secretary of Treasury James A. Baker. Intended to alleviate the debt problem, the "Baker Plan" proposed \$20 billion in additional lending by the commercial banks and \$9 billion in additional lending by the World Bank and the other development banks over three years. In return for this financial assistance participating countries are to undertake fundamental economic reforms. The fifteen proposed participants are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

The exposure of U.S. banks to these fifteen heavily-indebted countries has been of concern to many, including both regulators and the U.S. Congress. This report provides basic data on U.S. bank exposure in the fifteen countries for the period 1982 through September 1986.

Table 1 shows total exposure for all fifteen countries. After increasing from \$91.1 billion in 1982 to \$95.4 billion in 1984, loans dropped to \$86.0 billion in September 1986, a decrease of nearly 10 percent from their 1984 peak and 5.6 percent since 1982. This decrease in exposure highlights the difficulty of getting new financial resources to the debtor countries, a central feature of the debt strategy since 1982.

Table 1 also divides the total exposure in each country into amounts owed by the public and private sectors. The relative shares of public and private sector debt in the borrowing nations have shifted dramatically, almost reversing their shares between 1982 and September 1986. In 1982, public sector debt accounted for only 37.3 percent of the outstanding debt of the fifteen countries while private sector debt accounted for 62.5 percent. In September 1986, public sector debt accounted for 61.7 percent of the total debt of the "Baker Plan" fifteen, while the private sector accounted for only 38.3 percent. There may be a number of factors which account for this shift, including the consolidation of private sector debt into public sector debt, greater write-offs of private sector debt, and, possibly, greater difficulty of the private sector in obtaining new loans.

Table 2 shows the exposure of the nine largest U.S. banks (money center banks) in the "Baker Plan" fifteen countries. The nine banks include BankAmerica Corp., Continental Illinois Corp., First Chicago Corp., Citicorp, Chase Manhattan Corp., Manufacturers Hanover Corp., J.P. Morgan & Company, Bankers Trust New York Corp., and Chemical New York Corp. Exposure for these banks peaked in 1984 at \$60.0 billion and has since dropped to \$56.1

billion, only slightly above their exposure in 1982 of \$55.9 billion. Thus, loan exposure is down 6.5 percent from its 1984 peak, but up only very slightly — less than 1 percent — from its 1982 level. In effect, the level of outstanding loans to the "Baker Plan" fifteen from the nine money center banks has not changed since the onset of the debt problem in 1982.

The exposure of these banks relative to their assets also peaked in 1984 at 10.2 percent and has since declined to 9.0 percent, somewhat below its 1982 level of 9.5 percent. Relative to their capital, however, the picture is somewhat different. Exposure to the fifteen countries relative to capital has declined continuously — from 192.6 percent of capital in 1982 to 124.2 percent of capital in September 1986. This is the result of a 55.9 percent increase in capital during the period.

Table 3 produces the same data as in Table 2 for all banks other than the nine largest banks. The exposure of banks other than the money center banks peaked in 1983 at \$36.4 billion and has since declined to \$29.9 billion, 15.1 percent below their 1982 exposure of \$35.2 billion. Thus, since the exposure of the nine money center banks remained relatively constant, the drop in the total exposure of U.S. banks to the "Baker Plan" is attributable to the non-money center banks.

Table 3 indicates that the non-money center banks never were as exposed to loans in the fifteen countries as were the nine largest banks. In 1982 the exposure of the non-money center banks accounted for 38.6 percent of all U.S. bank loans to these fifteen countries and was equal to 62 percent of the exposure of the money center banks. By 1986, these figures had dropped to 34.8 percent and 53.0 percent, respectively. Moreover, the exposure of the non-money center banks measured relative to capital or to assets has been substantially less than the money center banks and has dropped continuously throughout the period. The ratio of loans to assets dropped from 5.2 percent in 1982 to 3.2 percent in September 1986. The ratio of loans to capital dropped from 84.7 percent in 1982 to 44.1 percent in September 1986. During the period the capital of these banks grew more than the money center banks, by 63.0 percent compared to 55.9 percent for the money center banks. Assets of these banks rose 37.1 percent during the period, compared to an increase of only 5.8 percent for the money center banks. In general, the non-money center banks have been relatively less exposed than the money center banks and this may go far to explain their relatively greater reluctance to continue to participate in "forced" lending to these fifteen troubled debtors.

In summary, the loan exposure of U.S. banks to the "Baker Plan" fifteen has dropped by 5.6 percent since 1982. The nine largest banks have maintained approximately the same exposure over the period but are now somewhat less vulnerable as a result of a substantial increase in their capital. The non-money center banks are also less vulnerable to the loans in these countries, both as a result of a substantial decrease in their exposure and as a result of a substantial increase in their capital and assets.

TABLE 1. Debt Owed to U.S. Banks by Public and Private Sectors
"Baker Plan" Fifteen
1982 - September 1986
(\$ millions)

COUNTRY	1982	1983	1984	1985	September 1986
ARGENTINA					
Public Sector	83,867.8	3,546.3	4,041.1	4,957.8	5,586.0
Private Sector	5,163.1	4,907.5	3,933.6	3,452.8	2,875.0
Total	8,230.9	8,503.8	7,974.7	8,410.6	8,461.0
BOLIVIA					
Public Sector	247.9	228.0	167.5	84.2	74.0
Private Sector	129.2	86.1	44.8	28.4	20.0
Total	377.1	314.1	212.3	112.6	94.0
BRAZIL					
Public Sector	7,295.6	8,250.2	11,918.2	12,711.2	13,401.0
Private Sector	13,141.9	12,482.3	11,950.2	10,584.4	8,713.0
Total	20,437.5	20,732.5	23,868.4	23,295.6	22,114.0
CHILE					
Public Sector	1,076.9	1,753.9	2,629.9	3,111.4	3,875.0
Private Sector	3,003.5	4,446.4	4,067.3	3,457.6	2,886.0
Total	6,080.4	6,200.3	6,697.2	6,569.0	6,761.0
COLOMBIA					
Public Sector	1,011.0	1,051.4	1,138.9	1,255.1	1,019.0
Private Sector	2,184.6	2,264.8	1,827.6	1,370.1	995.0
Total	3,195.6	3,316.2	2,966.5	2,625.2	2,014.0
ECUADOR					
Public Sector	756.7	1,238.3	1,728.4	1,939.0	1,773.0
Private Sector	1,272.1	847.8	415.2	203.1	362.0
Total	2,028.8	2,086.1	2,143.6	2,142.6	2,135.0
IVORY COAST					
Public Sector	496.2	451.9	394.3	318.9	348.0
Private Sector	148.0	93.5	76.2	38.8	53.0
Total	644.2	545.4	470.5	357.7	401.0
MEXICO					
Public Sector	9,696.9	12,007.8	13,552.9	13,364.5	14,261.0
Private Sector	14,679.8	14,329.7	13,022.0	11,569.7	9,484.0
Total	24,376.7	26,337.5	26,574.9	24,934.2	23,745.0

(continued)

TABLE 1. Debt Owed to U.S. Banks by Public and Private Sectors
"Baker Plan" Fifteen -- continued
1982 - September 1986
(\$ Millions)

COUNTRY	1982	1983	1984	1985	September 1986
INDONESIA					
Public Sector	388.8	338.5	380.4	415.0	488.0
Private Sector	387.7	572.0	530.6	489.7	427.0
Total	736.5	910.5	911.0	904.7	895.0
IGERIA					
Public Sector	1897.7	1,553.2	1,227.6	762.4	595.0
Private Sector	956.2	513.2	311.1	436.1	335.0
Total	1,853.9	2,066.4	1,538.7	1,198.5	930.0
INDIA					
Public Sector	915.6	1,409.9	1,590.3	1,149.7	938.0
Private Sector	1,823.7	885.3	766.6	506.5	377.0
Total	2,340.9	2,495.2	2,356.9	1,656.2	1,315.0
PHILIPPINES					
Public Sector	2,444.6	2,795.0	2,443.4	3,116.8	3,298.0
Private Sector	3,300.9	3,286.4	3,010.2	2,191.4	1,643.0
Total	5,745.5	6,081.4	5,453.6	5,308.2	4,941.0
URUGUAY					
Public Sector	639.4	835.1	890.9	796.6	805.0
Private Sector	280.8	213.8	172.6	116.0	98.0
Total	920.2	1,048.9	1,063.5	912.6	903.0
VENEZUELA					
Public Sector	4,841.5	5,346.1	5,374.6	5,125.2	5,220.0
Private Sector	8,733.8	5,911.0	5,438.0	4,965.2	4,725.0
Total	11,575.3	11,257.1	10,812.6	10,090.4	9,945.0
YUGOSLAVIA					
Public Sector	393.5	655.8	961.8	1,026.4	1,455.0
Private Sector	1,926.0	1,736.2	1,417.7	1,373.7	835.0
Total	2,319.5	2,432.0	2,379.5	2,399.1	2,090.0
TOTAL DEBT	\$91,087.2	\$94,227.4	\$95,373.9	\$90,524.2	\$86,024.0
Public Sector	36,130.1	41,711.4	48,199.2	49,832.5	51,116.0
Private Sector as a Percentage of Total	37.32	44.31	50.72	55.02	61.72
Private Sector	56,933.1	52,516.0	46,983.7	40,691.7	32,908.0
Private Sector as a Percentage of Total	62.68	55.72	49.28	45.02	38.28

(continued)

TABLE 1. Debt Owed to U.S. Banks by Public and Private Sectors
"Baker Plan" Fifteen -- continued
1982 - September 1986
(\$ Millions)

Note: Totals in Table 1 were arrived at by adding the two components of total debt, that is, public and private sector debt. Tables 2 and 3 use the published total debt figures. For the years 1982-1985, totals in Tables 2 and 3 will sum to "Total Debt" in Table 1, with a slight discrepancy due to rounding. In the data for September 1986, however, the published public and private sector debt figures sometimes do not add up to the published total debt figure. For some countries the amount of variance was greater than could reasonably be accounted for by rounding. As a result, there is a discrepancy of \$21 million between the sum of the public and private debt components and the published totals. Public and private sector debt add up to \$86,024. Published totals add up to \$86,003, which does coincide with the sum of the total exposure as shown in Table 2 and 3.

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council, Statistical Release E-16(126), Country Exposure Lending Survey, Various years.

TABLE 2. Bank Risk - "Baker Plan" Fifteen Countries
Nine Money Center Banks - 1982 to September 1986
(\$ millions)

COUNTRY	1982	1983	1984	1985	September 1986
ARGENTINA					
Exposure	\$5,125.2	\$5,351.8	\$5,106.1	\$5,874.7	\$5,914.0
% of Capital	17.7%	17.0%	13.9%	13.9%	13.1%
% of Assets	0.9%	0.9%	0.9%	0.9%	1.0%
BOLIVIA					
Exposure	230.2	199.4	119.4	58.5	48.0
% of Capital	0.8%	0.6%	0.3%	0.1%	0.1%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%
BRAZIL					
Exposure	13,296.2	13,298.4	15,800.2	15,550.1	15,000.0
% of Capital	45.8%	42.2%	43.1%	36.8%	33.2%
% of Assets	2.3%	2.3%	2.7%	2.5%	2.4%
CHILE					
Exposure	3,326.5	3,438.5	3,823.9	4,067.1	4,136.0
% of Capital	11.5%	10.9%	10.4%	9.6%	9.2%
% of Assets	0.6%	0.6%	0.6%	0.7%	0.7%
COLOMBIA					
Exposure	2,225.4	2,240.3	2,181.3	1,923.8	1,448.0
% of Capital	7.7%	7.1%	5.9%	4.5%	3.2%
% of Assets	0.4%	0.4%	0.4%	0.3%	0.2%
ECUADOR					
Exposure	1,152.4	1,228.7	1,335.0	1,365.3	1,366.0
% of Capital	4.0%	3.9%	3.6%	3.2%	3.0%
% of Assets	0.2%	0.2%	0.2%	0.2%	0.2%
IVORY COAST					
Exposure	491.2	403.9	333.0	252.5	295.0
% of Capital	1.7%	1.3%	0.9%	0.6%	0.7%
% of Assets	0.1%	0.1%	0.1%	0.0%	0.0%
MEXICO					
Exposure	12,861.6	14,127.1	14,693.3	14,087.3	13,428.0
% of Capital	44.4%	40.8%	40.0%	33.3%	29.7%
% of Assets	2.2%	2.4%	2.5%	2.3%	2.2%
MOROCCO					
Exposure	588.9	764.7	712.6	657.4	682.0
% of Capital	2.0%	2.4%	1.9%	1.6%	1.5%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%

(continued)

TABLE 2. Bank Risk - "Baker Plan" Fifteen Countries
Nine Money Center Banks - 1982 to September 1986 -- continued
(\$ millions)

COUNTRY	1982	1983	1984	1985	September 1986
NIGERIA					
Exposure	1,448.4	1,531.7	1,146.5	903.4	688.0
% of Capital	5.0%	4.9%	3.1%	2.1%	1.5%
% of Assets	0.2%	0.3%	0.2%	0.1%	0.1%
PERU					
Exposure	1,364.2	1,352.9	1,295.3	956.3	758.0
% of Capital	4.7%	4.3%	3.5%	2.3%	1.7%
% of Assets	0.2%	0.2%	0.2%	0.2%	0.1%
PHILIPPINES					
Exposure	3,881.6	3,930.7	3,756.1	3,790.8	3,567.0
% of Capital	13.4%	12.5%	10.2%	9.0%	7.9%
% of Assets	0.7%	0.7%	0.6%	0.6%	0.6%
URUGUAY					
Exposure	611.8	767.9	789.1	713.5	692.0
% of Capital	2.1%	2.4%	2.2%	1.7%	1.5%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%
VENEZUELA					
Exposure	7,803.9	7,635.7	7,435.1	7,127.6	6,744.0
% of Capital	26.9%	24.2%	20.3%	16.9%	14.9%
% of Assets	1.3%	1.3%	1.3%	1.1%	1.1%
YUGOSLAVIA					
Exposure	1,460.8	1,556.7	1,502.6	1,522.2	1,351.0
% of Capital	5.0%	4.9%	4.1%	3.6%	3.0%
% of Assets	0.2%	0.3%	0.3%	0.2%	0.2%
TOTAL					
Exposure	\$55,868.3	\$57,829.9	\$60,029.5	\$58,850.5	\$56,117.0
% of Capital	192.6%	183.6%	163.6%	139.1%	124.2%
% of Assets	9.5%	9.9%	10.2%	9.4%	9.0%
MEMORANDA:					
Capital:	\$29,000.0	\$31,500.0	\$36,700.0	\$42,300.0	\$45,200.0
Assets:	\$88,000.0	\$82,000.0	\$89,000.0	\$63,000.0	\$62,000.0

Note: The nine banks include Bank America Corp., Continental Illinois Corp., First Chicago Corp., Citicorp, Chase Manhattan Corp., Manufacturers Hanover Corp., J.P. Morgan and Company, Bankers Trust New York Corp., and Chemical New York Corp.

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council, Statistical Release E.16(126), Country Exposure Lending Survey, Various years.

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TABLE 3. Bank Risk - "Baker Plan" Fifteen Countries
Non-Money Center Banks - 1982 to September 1986
(\$ millions)

COUNTRY	1982	1983	1984	1985	September 1986
ARGENTINA					
Exposure	\$3,105.8	3,150.1	2,868.7	2,535.9	2,546.0
% of Capital	7.5%	6.6%	5.2%	4.0%	3.8%
% of Assets	0.5%	0.4%	0.3%	0.3%	0.3%
BOLIVIA					
Exposure	147.0	114.7	93.0	94.2	46.0
% of Capital	0.4%	0.2%	0.2%	0.1%	0.1%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%
BRAZIL					
Exposure	7,141.3	7,354.1	8,068.3	7,245.5	7,109.0
% of Capital	17.2%	15.4%	14.5%	11.5%	10.5%
% of Assets	1.1%	1.0%	1.0%	0.8%	0.8%
CHILE					
Exposure	2,753.9	2,762.0	2,873.5	2,502.0	2,398.0
% of Capital	6.6%	5.8%	5.2%	4.0%	3.5%
% of Assets	0.4%	0.4%	0.3%	0.3%	0.3%
COLOMBIA					
Exposure	970.3	1,075.9	785.2	701.6	566.0
% of Capital	2.3%	2.2%	1.4%	1.1%	0.8%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%
ECUADOR					
Exposure	876.6	857.5	808.9	777.3	768.0
% of Capital	2.1%	1.8%	1.5%	1.2%	1.1%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%
IVORY COAST					
Exposure	153.0	141.5	137.7	105.2	108.0
% of Capital	0.4%	0.3%	0.2%	0.2%	0.2%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%
MEXICO					
Exposure	11,515.1	12,210.5	11,831.6	10,847.0	10,318.0
% of Capital	27.7%	25.5%	21.3%	17.2%	15.2%
% of Assets	1.7%	1.6%	1.4%	1.2%	1.1%
MOROCCO					
Exposure	167.6	146.3	198.5	247.3	211.0
% of Capital	0.4%	0.3%	0.4%	0.4%	0.3%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%

(continued)

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TABLE 3. Bank Risk - "Baker Plan" Fifteen Countries
Non-Money Center Banks - 1982 to September 1986 -- continued
(\$ millions)

COUNTRY	1982	1983	1984	1985	September 1986
NIGERIA					
Exposure	405.6	534.7	392.3	295.1	240.0
% of Capital	1.0%	1.1%	0.7%	0.5%	0.4%
% of Assets	0.1%	0.1%	0.0%	0.0%	0.0%
PERU					
Exposure	1,176.8	1,142.4	1,061.5	697.9	556.0
% of Capital	2.8%	2.4%	1.9%	1.1%	0.8%
% of Assets	0.2%	0.2%	0.1%	0.1%	0.1%
PHILIPPINES					
Exposure	1,863.9	2,130.7	1,697.6	1,627.5	1,373.0
% of Capital	4.5%	4.4%	3.1%	2.6%	2.0%
% of Assets	0.3%	0.3%	0.2%	0.2%	0.1%
URUGUAY					
Exposure	308.5	281.1	274.4	199.1	210.0
% of Capital	0.7%	0.6%	0.5%	0.3%	0.3%
% of Assets	0.0%	0.0%	0.0%	0.0%	0.0%
VENEZUELA					
Exposure	3,771.4	3,621.6	3,377.5	2,962.8	2,699.0
% of Capital	9.1%	7.6%	6.1%	4.7%	4.0%
% of Assets	0.6%	0.5%	0.4%	0.3%	0.3%
YUGOSLAVIA					
Exposure	858.7	875.3	876.7	875.9	738.0
% of Capital	2.1%	1.8%	1.6%	1.4%	1.1%
% of Assets	0.1%	0.1%	0.1%	0.1%	0.1%
TOTAL					
Exposure	\$35,215.5	\$36,398.4	\$33,345.4	\$31,674.3	\$29,886.0
% of Capital	84.7%	76.0%	63.7%	50.2%	44.1%
% of Assets	5.2%	4.8%	4.3%	3.5%	3.2%
MEMORANDA:					
Capital:	\$41,600.0	\$47,900.0	\$55,500.0	\$63,100.0	\$67,800.0
Assets:	673,000.0	755,000.0	823,000.0	906,000.0	923,000.0

Source: Prepared by the Congressional Research Service from Federal Financial Institutions Examination Council, Statistical Release E-16(126), Country Exposure Lending Survey, Various years.

BANK TAX CONFERENCE 1983

TAX TREATMENT
OF
DOUBTFUL DEBTS INTERNATIONALLY

November 7, 1983
Hotel Atlantis Sheraton
Zurich, Switzerland

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INTRODUCTION

This study was prepared for the Peat, Marwick, Mitchell & Co. 1983 Bank Tax Conference. It presents in a summarized form the detailed information provided by the Peat Marwick offices listed on pages 164 and 165.

The main purpose of the study is to compare the tax rules applied to banks with regard to actual and anticipated loan losses, despite the terminology nuances which may exist between the various countries and territories. We hope that we have partially overcome this problem in the definitions which precede the summary (page 2).

By summarizing the information for this purpose, it is believed that the details given will prove to be a useful guide to the rules in each country and territory. It will be appreciated, however, that the information is evidently abbreviated and if may be necessary to consider the position of an individual country or territory in more detail.

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TAX TREATMENT OF LOAN LOSSES INTERNATIONALLY

I. DEFINITIONS

"ACTUAL LOAN LOSS": tax deduction for a loss when adequate legal remedies have been exhausted.

"PROVISION FOR LOAN LOSS": tax deduction for anticipated loss before all adequate legal remedies have been exhausted (verb: "TO PROVISION").

"WRITE-OFF" or "WRITE-DOWN": the amount of reduction in value of an individual loan on the asset side in the books for an "ACTUAL LOAN LOSS" or "PROVISION".

"RESERVE": a separate account in the books to "PROVISION" a specific loan or a group of loans. This account may be shown either on the liability side or setted against loans on the financial statements.

II. SUMMARY OF RULES APPLIED IN 27 SELECTED COUNTRIES

A. "Provision" is not allowed

Only "write-offs" for "actual loan losses" permit tax deductions.

Australia (in fact, write-off may be based on subjective determination before all legal remedies are exhausted)

Venezuela

B. "Provision" is allowed

1. "Actual loan losses" not covered by previous "provisions" permit direct tax deductions.

a. "Provision" only through specific "reserves"
Belgium (reserves not to exceed 7.5% of best of five year's profits; conditions for write-off very strict)

Mexico

b. "Provision" through "write-offs" and/or specific "reserves"

Argentina
Channel Islands
Hong Kong
Ireland
Malaysia
Singapore
United Kingdom

TAX TREATMENT OF LOAN LOSSES
INTERNATIONALLY
(continued)

c. "Provision" through "write-offs" or general "reserve"

	Limitation of General Reserve			
	Experi- ence	Flat Rate	Loans	
	Ratio	Rate	All	Most
- Option for reserve method is final, write-offs for actual loan losses may determine a tax deduction through replenishment of the reserve U.S.A. either or		0.5	*	*

d. "Provision" through specific and general "reserves"

	Limitation of General Reserve				
	Experi- ence	Flat Rate	of not specifically provisioned loans		Medium and long term
			All	Most	
- General reserve is optional					
France	-	0.5	-	-	*
Luxembourg	-	1 - 1.5	-	*	-
The Netherlands	-	1 - 1.5	-	*	-
Portugal	-	5	*	-	-
- General reserve is compulsory					
Austria	-	0.5 - 3	-	*	-
Japan (no tax deductible provision for country risk yet)	*	0.3	-	*	-
Norway	-	0.1 - 1	-	*	-

TAX TREATMENT OF LOAN LOSSES
INTERNATIONALLY
(continued)

e. "Provision" through specific or general "reserves"

	<u>Limitation of General Reserve</u>		
	<u>Flat</u>	<u>Loans</u>	
	<u>Rate</u>	<u>All</u>	<u>Most</u>
- Freedom of choice			
Denmark	3	e	-
Switzerland	1 - 5	e	-
- Deduction of at least specific provision			
Brazil	1 - 1.5	-	e
- Deduction of the higher of the specific or general provision			
Spain	1 - 1.5	-	e

f. "Provision" only through general "reserve"

	Limitation of General Reserve		
	Flat %	Loans	
	Rate	All	Most
Italy	5	-	*
Greece (only additions to reserve are limited)	-	-	-
Norway	5	*	-

TAX TREATMENT OF LOAN LOSSES
INTERNATIONALLY
(continued)

2. "Actual loan losses" not covered by "provisions" do not directly permit tax deductions.

Canada

"Write-offs" and specific "provisions" are charged net of recoveries to a general reserve, which then may be replenished through deductible additions, but the additions to the reserve are limited according to a calculation including a five-year loan loss experience ratio.

An additional deduction is allowed if the general reserve has not reached 1 - 1.5% of most credit (after specific provision).

ARGENTINA

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts are computed on a case-by-case basis. General provisions are legally admissible but in practice are never used.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Provision made on a case-by-case basis in accordance with Argentine accounting principles are normally tax deductible. Hidden reserves are prohibited. A general provision for contingent liabilities, even though possibly required by auditors, would not be tax deductible, thus resulting in a difference between book and tax accounting.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Yes.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities may not disallow provisions in closed years unless they impact ongoing inflation adjusted tax loss carryovers.

ARGENTINA
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectible loan eventually written off?

Balance sheet treatment does not rule for tax purposes and both write-offs and reserve creation can be deductible.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements lower in the banking business than in other sectors?

Acceptable evidence is based on facts and circumstances, the most important of which is indication of default to demand payment. Banks and non-bank organizations follow basically the same rules.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

No.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Tax Authorities concerning country risk.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

In general, no.

6. In timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is a relevant factor but, because of permitted inflation adjustments, it generally does not come into play.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Yes and yes.

ARGENTINA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
- individual agreement with the Tax Authorities?
- specific recommendations from the Banking Authorities?
- individual agreement with the Banking Authorities?
- accepted common practice?
- other?

General provisions are not used.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

4. Are credits which have been secured included in the basis of calculation for the general provision?

5. How is the amount of the provision determined?

6. If it is by application of rates fixed by law or regulations, what are these rates? If general rates are used for different kinds of credits, list the credits.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

8. May general provisions, although deducted for tax purposes, be considered as a augmentation of retained earnings, and thus be included in the bank's equity for accounting purposes?

2-8 are not applicable.

AUSTRALIAA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

No tax deduction is allowed on provisions for loan losses (either specific or general). Tax deductions are allowed only as specific loans are actually written-off in the accounting records.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No ceiling is imposed on the amount that may be deducted as a result of loan write-offs.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Amount deducted for tax cannot exceed amount actually written off in the books of account. Thus book reserve could (and usually does) exceed tax deductible amount to the extent that specific loan loss provisions are made, but not written off, and general (non-specific) provisions are created.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Yes.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Authorities would always allow deduction in the year of write-off. Tax audits may encompass previous seven years and it is possible that an audit may result in adjustments to previously allowed deductions.

AUSTRALIA
(continued)B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

General provisions are created to cover unspecified losses: usually calculated as a percentage of average loan portfolio. Specific provisions are created in respect of particular loans once collectability is in doubt. The gross value of the loan will be retained in the books. Once it is judged that a portion of a loan will not be repaid, the gross value of the loan will be written off as appropriate, and the specific provisions adjusted accordingly. It is this write-down which leads to the tax deduction.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Tax Authorities do not seek to obtain specific evidence as to need for a write-off, although this may be covered in the event of a tax audit. This issue is whether the lender makes a bona fide assessment, at the particular point in time, that taking all the relevant circumstances into account a particular debt is bad and, if so, what amount should be written off. The Tax Authorities recognize that such assessments may prove to be inaccurate and an amount written off may subsequently be recovered. In the event of a tax audit, credit files, loan committee minutes, board minutes, etc. could be reviewed to determine whether reasonable assessments of write-offs had indeed been made. It should be noted that a mere "risk of loan loss" is not enough: the loan must be judged to be irrecoverable.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Only if justifying a write-off. (Refer B.2. above).

AUSTRALIA
(continued)

B. Specific Provisions (continued)

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

Tax Authorities have not taken a position with respect to specific country risks. Again, the considerations in B.1. and B.2 above apply.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Restructuring is relevant only to the extent that it provides evidence as to extent of final recovery or write-off.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is not a critical factor as the tax deduction is allowed when loan is written off in the books of the bank.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

When a loan becomes doubtful, the first stage is to classify it as "reserved interest": interest will be added to the amount receivable, but will be fully provided for. Such interest must be added back to the accounting income when arriving at taxable income. The next classification of loan would be "interest not charged". For such loans, the Tax Authorities do not require any notional interest income to be brought to account.

AUSTRALIA
(continued)

C. General Provisions

(Note: Banks are not permitted tax deductions for general loan loss provisions. The following responses therefore deal only with the accounting aspects and are given for information only).

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

Accepted common practice.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Provisions computed by applying a percentage, determined on judgement basis (taking account of, historic and expected loan loss experience) applied to average loan balances for the current year. Movements in provision are charged/credited to income over a period of years to smooth temporary aberrations. (Refer also to B.1 above).

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes.

5. How is the amount of the provision determined?

See C.2.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Rates are not fixed by law or regulations.

AUSTRALIA
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

Cannot be deducted for tax purposes. General provisions are deducted from gross amount of loan to arrive at the net figure to be included in the balance sheet.

AUSTRIA

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provisions for loan losses are computed on a loan-by-loan basis when risks become evident and a loss will probably occur.

In addition, a general reserve for not specifically provided debts is prescribed by law (see General Provisions, item C).

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

Except the above-mentioned general reserve, for the computation of which specified accounting procedures exist, there is no ceiling to the total amount of (specific) provisions for loan losses deductible for tax purposes.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Provisions made on a case-by-case basis in accordance with Austrian accounting principles (i.e. the decisive prudence concept) are normally tax deductible in full. A hidden reserve only may arise when a specific provision already provided for, is - for reason of conservative accounting principles - not immediately released. The general reserve is to be considered as part of the bank's equity.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deductible at full rate.

AUSTRIA
(continued)

A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The tax authorities can disallow provisions irregularly allocated during years which are barred by the statute of limitation only in the first year which is open to a tax audit, provided that the provision is still maintained in that particular year.

AUSTRIA
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

According to the statutory format of a bank's balance sheet the general reserve (item A.1) must be shown as a separate item on the liability side. Specific provisions on doubtful accounts are according to general practice deducted directly from the debtors. Bad debts are written off when adequate efforts (including legal action) have been made without success; the resulting loss is then charged to the reserve.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Objective facts which make the risk of loan loss probable are primarily an adverse financial situation of the debtor in connection with the non-existence of adequate and/or realisable collaterals. Default of payment at due date alone does not justify a provision. In general for bankers is admitted a greater reliance on their evaluation of possible loan risks.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The blocking of funds abroad by foreign Exchange Control Authorities would legitimate their provisioning.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

In respect of country risks the local Tax Authorities did not make any official statement until now. Austrian banks, which are involved in this problem have provided against country risks up to a percentage of 40% of the outstanding amount. It is probable that such provisions will be allowed by Tax Authorities.

AUSTRIA
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A rescheduling of a loan without additional collaterals to be furnished by the debtor would justify maintaining an already existing provision.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

In principle, a provision has to be made in the year during which the events occurred which would justify the provision. As it is often very difficult to prove the exact timing of such an event the problem of tax deductibility in an individual fiscal year is of minor importance.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Interest on bad debts which is already recorded is usually provisioned in the same way as the principal.

AUSTRIA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

A general provision is made in accordance with the Austrian Banking Legislation and is acknowledged by the Tax Authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes.

5. How is the amount of the provision determined?

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

2, 3, 5, 6. All loans and contingent claims other than those specifically provisioned and those due from banks or the Republic of Austria, Austrian states or municipalities* are subject to a general provision as follows:

AUSTRIA
(continued)

C. General Provisions (continued)

	Banks in legal form	
	of general or limited partnership	of joint stock corporations or limited liability companies
Bills		
own drawings	3.0%	2.0%
other	1.5%	1.0%
Loans		
granted against charges on real estate	0.5%	0.5%
other	3.0%	2.0%
Contingent claims		
in respect of bills in circulation drawn by the bank as well as endorse- ment on rediscounted bills	1.5%	1.0%
Contingent claims in respect of guarantees, guaranteed bills and cheques as well as guarantee agreement	3.0%	2.0%

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

See A.3.

* loans to municipalities are subject to a 0.5% general provision.

Belgium

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts must be computed on a loan-by-loan basis only. However, negotiations have started between the Banking Association and the Ministry of Finance to also accept a provision computed on a global basis, within certain limits.

General provisions are, presently, considered as allocation of profits and consequently are taxable.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

From a banking point of view, there are no limitations. However, from a tax point of view, only specific provisions will be acceptable if they meet the following conditions:

- (i) the losses must qualify as business losses. They must be well defined and they have to result from circumstances occurred during the taxable period. They may not relate to accounts receivable which are represented by securities.
- (ii) the amount of the tax-free provisions set up during a given financial period may not exceed 5% of the taxable profit of that year (increased by the amount of these tax-free provisions). Moreover, the total of the tax-free provisions remaining at the end of any taxable period may not exceed 7.5% of the highest taxable profit of any of the five preceding taxable periods.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

As specific provisions can be set up when the management of a bank feels, in prudence and good faith, that the collectibility of a specific loan has become doubtful, it is possible that the specific provision exceeds the amount which would actually be needed. That excess could lead to a hidden reserve if the total specific provisions do not exceed the limits described under 2 (ii) above.

BELGIUM
(continued)

A. General (continued)

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deducted from trade income subject to corporate tax at the rate of 45%.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

In the year of discovery, the Tax Authorities can disallow provisions deducted during the years which are barred to auditing by the statute of limitations. The provisions will be considered as an under-evaluation of the assets and hence be subject to corporate tax for that year.

BELGIUM
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

(i) For tax purposes, the write-off of bad debts requires, in principle, objective proof of the uncollectibility of the claims after exhaustion of the guarantees in favour of the bank. Such objective proof can, for instance, be provided at the close of the bankruptcy procedures and after liquidation of the existing guarantees.

A write-off would also be accepted for tax purposes if it can be demonstrated to the satisfaction of the tax inspector that there was, reasonably speaking, no hope at all of collecting either part or the entire amount of the debt. An example of adequate proof would be a certificate, issued by the receiver of a debtor in bankruptcy, prior to the close of the bankruptcy procedures and stating that the bank should not expect more than a given percentage of its claim. Some discussions have taken place between the Banking Association and the receivers and an agreement has been reached with regard to the type of certificate receivers would have to issue in the future.

(ii) If the direct write-off cannot be substantiated, a reserve for bad debts has to be set aside in the balance sheet. Such reserve is deducted from the assets. A loan is written off when every adequate effort (including legal action) has been made without success. The loss resulting from the write-off is then charged to the reserve.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The basic criterion for setting up provisions for probable loan losses is the belief of management of the company that the collectibility of either part or the entire amount of specific loans has become doubtful during the financial period concerned. This opinion should be supported by objective facts and circumstances that have come about during that financial period. In this respect, it is advisable that for each doubtful claim a dossier be constituted containing the above objective elements and the formal opinion of management.

BELGIUM
(continued)

B. Specific Provisions (continued)

There is no looser evidence requirement in the banking business than in other sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor could justify a tax deductible provision but only within the limits described above (A.2).

The blocking of payment of interest matured during a given year could, under certain conditions, be considered as a non-accruing taxable income for that year. It would become taxable only in the year it is actually collected.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Tax Authorities concerning country risks. Belgian banks have in general taken the position that such provisions are taxable except for the portion of the provision which would qualify for the tax-free statute.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

The rescheduling of a debt does not necessarily mean that the loan is less doubtful. As a consequence, the management of a bank could decide to set up a provision notwithstanding the fact that a rescheduling of the debt has or will take place.

Interest which might be forgiven as part of a rescheduling is a direct loss deductible from taxable income. Interest which might be capitalized as part of a rescheduling would still constitute taxable income as it is considered as realized or produced during the financial year.

BELGIUM
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

A provision would, in principle, be disallowed if it is not set up during the fiscal year during which the event occurred which makes the loss probable. Deduction of the provision will be admitted when the loss is definite.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to accrue, in general, interest on bad debts and to provision them fully, as outlined under A.2.

BELGIUM
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are made in accordance with general recommendations from the Banking Authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Any unsecured credits may justify a general provision.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of calculation for the general provision?

No.

5. How is the amount of the provision determined?

The amount of the provision is left to the discretion of the Board of Directors.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

BELGIUM
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No limit.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

General provisions are not deductible for tax purposes, but they form part of the bank's equity for banking purposes.

BRAZILA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

The minimum required provision for loan losses is computed on a case-by-case basis. However, banks are permitted to deduct a larger provision for tax purposes to the extent that either 1 1/2% of all loans excluding those collateralized by a mortgage or lien on property, or 1% of all loans, exceeds this minimum. There are no regulations governing the calculation of a general reserve and consequently any provision in excess of the minimum required is at management's discretion.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is theoretically no ceiling on the loan loss provision; however, the maximum amount which is tax-deductible is the largest of the following:

- (a) Minimum provision computed on a case-by-case basis (the Central Bank has special regulations determining whether certain loans should be provided for or not).
 - (b) 1 1/2% of all loans outstanding excluding those collateralized by a mortgage or lien on property.
 - (c) 1% of all loans outstanding.
3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Since the maximum provisions deductible for tax purposes may exceed the provision actually needed, there exists the possibility of hidden reserves. Conservative management would be the only reason for providing in excess of the tax deductible provision; accounting principles on their own would not result in such a situation.

BRAZIL
(continued)A. General (continued)

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deductible from the basis of assessment at full rate.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

No.

BRAZIL
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The gross value of a loan which is considered doubtful remains unchanged when a loan loss is anticipated and a reserve is created separately on the balance sheet. The loan is written off when it is legally no longer collectible, (i.e. bankruptcy, etc.) or after 60 days of the constitution of the specific provision, within a maximum of 160 days.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The Tax Authorities accept the Central Bank of Brazil regulations which require commercial banks to constitute a specific provision when any loan is ninety days or more past due. This is somewhat looser than in other sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Not applicable - banks resident in Brazil do not lend overseas.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

Country risk is not accepted by the Tax Authorities as a justification for a specific provision.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Management may consider it prudent to maintain such a provision but for tax purposes it would only be deductible if it fell within the general provision limits.

BRAZIL
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

As mentioned in 2. above, the Tax Authorities accept the Central Bank of Brazil time criteria when considering the deductibility of a specific provision. The deduction is the provision recorded in the books and therefore timing is not a relevant factor.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

No.

BRAZIL
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The general provisions (1 1/2% of all loans outstanding excluding those collateralized by a mortgage or lien on property or 1% of all loans outstanding) are made in accordance with Central Bank of Brazil regulations.
2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The general provision is calculated on all loans.
3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Yes.
4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes.
5. How is the amount of the provision determined?

On a straight percentage basis.
6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

1% on all loans outstanding or
1 1/2% on loans outstanding less those collateralized by a mortgage or lien on property.

BRAZIL
(continued)

C. General Conditions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No.
8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

CANADA

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

A bank first reviews its portfolio on a loan-by-loan basis and makes specific provisions as required based upon that review.

In addition to the specific provisions, a general provision computed on a global basis is also permitted.

The amount of the general provision which is allowed as a deduction for tax purposes is determined under Rules issued each year by the Inspector General of Banks.

The specific and general provisions are accounted for separately and are charged against income as described below.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

The Rules fix a ceiling on the amount of the general provision which may be claimed as a deduction in computing income for tax purposes each year.

There is no limit on the amount of specific provisions which may be recorded in the accounts but the Rules determine the amount to be charged to profit and loss each year in respect of specific provisions and bad debt losses. This is the "Five-Year Average Loan Loss Experience" amount.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

The general provision which is computed on a formula basis could exceed the amount actually needed to provide for unknown but anticipated losses at the year-end.

CANADA
(continued)

A. General (continued)

An excess fiscal provision would not lead to a hidden reserve, as the Appropriations for Contingencies is shown as a balance sheet account in the Capital and Reserve section of the balance sheet. The financial statements of Canadian banks now comment in some length on the makeup of Appropriations for Contingencies.

In addition to the tax deductible general appropriation, a bank may also establish a tax paid provision as part of its Appropriations for Contingencies. Some of the large Canadian chartered banks still carry substantial balances in the tax paid appropriations. Others classify these amounts as part of the General Reserve. The changes each year in this portion of the total appropriations are set out, and the total account is described in some detail, in the notes to the financial statements so that a shareholder who is willing to make the effort to obtain an understanding of the system of providing for doubtful debts and potential future loan losses would be informed of the current position of a particular bank in this regard.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

The tax deductible provisions for doubtful debts and loan losses are allowed as a deduction in computing income for tax purposes on which corporate tax at full rates is assessed.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The technical right of the Tax Authorities to reverse a provision, either specific or general, deducted in a prior year is not clear. The Income Tax Act permits a bank to deduct provisions for credit losses which "in the circumstances are not in excess of the reasonable requirements of the bank". In practice, the detailed complex rules issued annually by the Ministry of Finance are the basis for the computation of the provisions which are deducted for tax purposes. The shareholders' auditors are required by the Inspector General of Banks to audit the returns provided by the banks with respect to this calculation each year. The Inspector General of Banks in turn notifies the Department of National Revenue that the provisions as calculated are in order. In practice, no difficulty is encountered in this area as the provisions deducted by the banks are not questioned by tax auditors from the Department of National Revenue.

CANADA
(continued)

A. General (continued)

are required by the Inspector General of Banks to audit the returns provided by the banks with respect to this calculation each year. The Inspector General of Banks in turn notifies the Department of National Revenue that the provisions as calculated are in order. In practice, no difficulty is encountered in this area as the provisions deducted by the banks are not questioned by tax auditors from the Department of National Revenue.

CANADA
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

When a specific provision is considered to be required for a particular loan, the provision is usually set up as a separate account although it is deducted from the principal amount of the loan to which it relates for balance sheet presentation purposes. At the time the loan is considered to be uncollectable both the loan account and the provision account would be closed and any differences between those two balances would be charged to the Appropriation for Contingencies account. This amount would be taken into consideration in the calculation of the "Annual Loss Experience" for the particular year. The loan and provision balances may be transferred to a loan realization account as an intermediary step. Any realization on security would be credited to this account and the resulting net loss would eventually form part of the Annual Loss Experience.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

All of the factors which would influence the management of the bank, and the shareholders' auditors, in determining whether a specific provision was required for a particular loan would also be considered by the Tax Authorities. In Canada the requirement which would be applied in the banking business would not be considered looser than those applied to any commercial enterprise.

Over the years case law has been built up supporting the position that the judgement of the management of the creditor company should generally override an opinion formed after the fact by a tax auditor unless there was fairly strong evidence to suggest that the conclusion reached by management was not objective.

In practice, we have had very little difficulty with the Tax Authorities questioning the need for provisions for doubtful debts. This reflects the fact that the Inspector General of Banks reviews these provisions each year using the work of the shareholders' auditors and subsequently advises the Tax Authorities whether the credit loss provisions are reasonable.

CANADA
(continued)

B. Specific Provisions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restrictions imposed by the government of a debtor's country of residence would not justify a tax deductible provision. The Canadian Income Tax Act does permit a taxpayer to defer payment of tax where exchange controls imposed by the debtor's country of residence prevent the collection of amounts of income which the taxpayer has been obliged to report for Canadian purposes. In practice, we have found this measure to be very rarely invoked. We are not aware of a case where a bank has utilized it.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

To our knowledge the Canadian Tax Authorities have not taken a position as to the relevance of country risk to justify a specific loan provision. The position of the Inspector General of Banks to date has been that specific provision for particular country risk positions may be desirable but it has not as yet been required, so far as we are aware.

We are not aware of bank clients specifically providing against country risk loans, but such loans would enter into the base upon which the general appropriations ceiling is calculated. There could therefore be considered to be, indirectly, a general provision in respect of country risks as well as commercial loans.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A provision made with respect to a doubtful loan may be maintained if the loan is restructured. However, if the restructuring involved a change from a direct loan to the holding of some kind of equity issued by the debtor, the position of the bank may be changed because of the technical requirements of various provisions of the Rules governing the computation of loan losses and the calculation of provisions for doubtful debts.

If, for example, a bank were to accept preferred shares of a debtor corporation in a restructuring in place of a loan the tax treatment of a provision for doubtful debts could change.

CANADA
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is not a relevant factor vis-a-vis the tax deductibility of the provision for loan losses. The Rules require a bank to make an annual charge against income for financial statement purposes to amortize provisions for losses and actual losses from the Appropriations for Contingencies account to the Income Statement. The bank is not obliged to claim this amount for tax purposes in the year of the transfer, and may defer the deduction if that is in its best interests from a tax planning point of view.

A bank is not obliged to establish a general Appropriation for Contingencies although an amount may be claimed for tax purposes that has not been recorded in the financial statements. A transfer to tax deductible general appropriations which is recorded in the financial statements need not be claimed in that year for tax purposes.

The issue of the timing of the tax deduction as opposed to the financial statement expense was a contentious and unclear area until quite recently. However, amendments to the Rules in the last couple of years have now largely resolved the problem.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

The Canadian Income Tax Act specifically requires a bank to bring into income, interest accrued to the year-end date on all loans on its books. This rule applies whether or not a provision has been established. In practice the requirements of the Income Tax Act have not always been strictly followed. Because the provisions which are set up do not give rise to an immediate tax deduction but rather flow through the appropriations account this revenue recognition requirement can give rise to a potentially serious tax timing problem for banks. This is an issue which has received considerable attention and is under discussion with the Inspector General of Banks office but has not yet been resolved. We expect that the 1983 edition of the Rules will deal with this situation.

CANADA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

Section 26 of the Canadian Income Tax Act provides a statutory basis for the deduction by banks of provisions which are not in excess of the reasonable requirements of the bank. This ceiling is to be determined by the Minister of Finance and is achieved through the issue each year of the Rules governing the calculations.

There are no individual agreements between specific banks and the tax authorities with respect to provisions for doubtful debts. Very rarely, unusual problems may arise which will be discussed with the tax authorities and a particular resolution obtained.

The Inspector General of Banks office controls the determination of the tax deductible provisions by banks. This is done through the Rules which are issued each year. The Inspector General of Banks office is very receptive to comments from banks and from the shareholders' auditors with respect to problems and suggestions with regard to these rules.

If a particular bank encounters specific problems with respect to the application of the Rules to its circumstances it, and/or its auditors, may, and unlikely would, approach the Inspector General of Banks office to seek a resolution. While this could not be described as common we are aware of instances where unusual circumstances have made resolution of a particular problem necessary.

Although the Rules are fairly detailed there are still a number of areas where practices in their application have grown up. These common practices from time to time will give rise to problems as circumstances change. In particular, the question of when a loan should be classified as "non-current" or a "problem loan" has been based upon practices which have varied between banks. Recently the Inspector General of Banks has proposed some more specific guidelines to deal with this area.

CANADA
(continued)

C. General Provisions (continued)

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The kinds of credits which may be included in the base for computing the general provision are quite extensive. These are described as eligible assets in the rules issued each year.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

A bank may include credits for which a specific provision has been made in the basis for the calculation of the general provision. They may, however, include in this calculation only the net balance after deducting the specific provision.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Credits which have been secured are included in the basis of calculation for the general provision with certain exceptions.

5. How is the amount of the provision determined?

The amount of the general provision is limited to 1.5% of the first two billion of eligible assets and 1% of assets in excess of that amount.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

The rates determining the maximum amount of the provision are described in the commentary referred to in question 3.

CANADA
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

There are annual limits on the increase in the general reserve limit. These yearly limits include:

- (a) the amount required to bring the general reserve to the maximum allowed.
- (b) one-third of the maximum general reserve permitted.
- (c) the annual income of the bank before taxes and before extraordinary items.

These limits are established each year in the regulations and are subject to change.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

The general provision although allowed as a deduction for tax purposes is commonly regarded as part of the equity of the bank and is included on the balance sheet in the section entitled "Capital and Reserves".

CHANNEL ISLANDS

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts must be computed on a loan-by-loan basis (specific provisions only).

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on specific loan loss provisions.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Specific provisions on the basis of generally accepted accounting principles, are normally allowable for taxation purposes but in the event that they are disallowed then the book reserve could be in excess of the tax deductible provision.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are deductible from assessable profits at full rate. Where an existing substantial banking enterprise wishes to extend its activities into, say, large scale Euro dollar loans arranged outside the Island, then by negotiation, a management charge which can be up to 90% of the interest turn may be paid to an associated bank or fellow branch. As part of this arrangement no loan loss claims will be accepted against taxable income. This arrangement, which must be the subject of individual negotiation may be looked at as the equivalent of a general loan loss reserve.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

If provisions have been disallowed as not being proved to be a bad debt then they would be allowed when they are eventually provable.

CHANNEL ISLANDS
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The estimated amount of the loss must be written off the gross amount of the loan and the net amount shown in the balance sheet.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Evidence indicating that the loan was not collectible such as statement of borrower's current position or evidence of legal action taken to recover the loan could be required to support a specific provision. However, it is normal for the auditor's confirmation or explanation of irrecoverability to be accepted.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

If the loan (capital or interest) is not collectible due to a restriction such as Exchange Control being permanent then an appropriate specific provision would be tax deductible.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No firm position has been taken by the Tax Authorities as to the relevance of country risk but it would undoubtedly be accepted as a factor in assessing collectibility.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A specific provision made against a loan which was restructured would be considered in the light of all other relevant facts. The restructuring of the loan would not, of itself, be conclusive evidence of collectibility.

CHANNEL ISLANDS
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Tax deductibility of specific provisions would not be challenged if not claimed in the fiscal year indicated by the event which made the loss probable.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Interest on loans against which specific provisions have to be made need not be taken into income.

CHANNEL ISLANDS
(continued)

C. General Provisions

1. Are general provisions made in accordance with:

- specific tax legislation?
- individual agreement with the Tax Authorities?
- specific recommendations from the Banking Authorities?
- individual agreement with the Banking Authorities?
- accepted common practice?
- other?

General provisions are not regulated by fiscal or banking authorities but are made on accepted common practice group formula and/or previous experience. Normally therefore general provisions are not tax deductible except where the large number, small individual size and similarity of loans means that it is impracticable to examine each loan at year end. In these exceptional circumstances a general provision based on previous experience may, by negotiation, be accepted.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Not applicable.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Not normally.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Usually yes.

5. How is the amount of the provision determined?

See above C.1.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

CHANNEL ISLANDS
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not applicable.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

Not applicable.

DENMARK

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provisions), or are both systems combined?

The Tax Authorities permit financial institutions to calculate, and deduct for tax purposes, reserves for loan losses by either:

- (a) a reserve calculated as a percentage of the loan and guarantee portfolio, i.e. a "general reserve" or
- (b) individual reserves based on an evaluation of the risk related to each loan or guarantee.

The two principles cannot be combined.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

From 1978, the Tax Authorities permitted financial institutions to create an annual reserve equivalent to a maximum of 1% of their total loan and guarantee portfolio. However, for the years 1978, 1979 and 1980, the maximum annual addition to the reserve was limited to 1% of their total loan and guarantee portfolio.

The Bank Supervision has stipulated that all loan loss reserves in the financial statements, including this general reserve, should be related to specific individual engagements.

Specific provisions are not subject to any regulatory limitation.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

A general reserve deductible for tax purposes could exceed the amount actually required and lead to a hidden reserve in the situation where the reserve has been set up primarily for the purpose of reducing the bank's tax liability.

Conservative accounting principles could lead to a book reserve principle as well as the individual reserve principle.

DENMARK
(continued)

A. General (continued)

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Losses for loans and guarantees are always deductible from the basis of assessment of corporate tax at the full rate.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities can disallow provisions deducted during the previous 5 years. A reduction by the tax authorities can only be expected if the general reserve exceeds the 1% limit or if, when using individual reserves, these are considered to exceed the actual or probable losses.

It should, however, be noted that the Tax Authorities so far have not considered it necessary to control individual reserves, which, in total, do not exceed 1% of the loan portfolio. Due to the present economic difficulties, it is the opinion of the Tax Authorities that individual reserves exceeding the 1% limit, but not exceeding 1% of the loan portfolio, shall not necessarily result in a control.

Any reversals will be made in the tax return in the year in which the deduction was made.

DENMARK
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Uncollectible loans can be written off when the loss is realized. The charge can be made either against a reserve or directly to earnings. The reserve is netted against the related asset line in the statutory financial statements and the amount thereof is, therefore, not disclosed.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

A specific provision against a loan requires documentation proving that a loss is probable. This documentation could be official notification informing of liquidation, bankruptcy etc. or documentation for legal action taken by the bank proving that a loss is probable.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

If Exchange Control restrictions result in doubtful loan fulfilling the requirements as described above, a tax deductible provision can be set up.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Tax Authorities concerning country risks.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A provision for a loan being restructured will depend on an evaluation of the loan after the restructuring.

DENMARK
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

The reserve can be deducted as long as the asset concerned is on the books.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to record interest accrued on bad debts and they are allowed to make full provision therefore.

DENMARK
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The only general provision which is tax deductible is the 3% provision, which is provided for by an administrative resolution from the Tax Authorities, based on negotiations with the Banker's Association.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The provision is computed on the basis of loans and guarantees at December 31, the statutory year end for Danish Banks.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes, the general provision is based on the total loan and guarantee portfolio, irrespective of security.

5. How is the amount of the provision determined?

The amount of the provision is determined as follows:

- (a) specific reserve, an evaluation of the risk related to each loan or guarantee
- (b) general reserve, a maximum of 3% of total loan and guarantee portfolio.

DENMARK
(continued)

C. General Provisions (continued)

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

There is no longer a limit applicable to the yearly increase (see A.2.).

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

FRANCEA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts must be computed on a case-by-case basis. However, banks are permitted to deduct a regulatory general reserve computed on their medium and long term credit portfolio.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No, insofar as specific provisions (as opposed to the regulatory general reserve on medium and long term credit) are not subject to any regulatory limitation.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Provision made on a case-by-case basis in accordance with French accounting principles are usually tax deductible. However, a hidden reserve may result from the setting-up of a regulatory general reserve on medium and long term loans for the sole purpose of reducing the bank's tax liability. On the other hand, a general provision for contingent liabilities, even though possibly required by auditors, would not be tax deductible, thus resulting in a difference between book and tax accounting.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Losses for loans are normally deductible from trade income subject to corporate tax at the rate of 50%. This may be different only if the loan takes the form of securities.

In this case, the provision is fiscally treated as a capital loss and can be offset only against capital gains subject to long term capital gains at tax the rate of 15%. Capital losses can be carried forward for 10 years.

FRANCE
(continued)A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities may at any time disallow provisions which have been irregularly allocated initially. Reversion of the provision to profits is made in the accounts of the year during which it was deducted, or in the accounts of the first year which is open to a tax examination, even though the provision may have been spontaneously reversed later by the bank.

FRANCE
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Doubtful loans cannot be written off directly as long as the loss is not realized, but a reserve for bad debts has to be posted on the balance sheet. Reserves in French Franc denominated loans are recorded as a negative item on the asset side. Reserves on loans denominated in foreign currencies are generally posted on the liability side of the bank's balance sheet and adjusted at every year end with reference to currency exchange rates. A loan is written off when every adequate effort (including legal action) has been made without success. The loss resulting from the write-off is then charged to the reserve.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Default of payment at due date alone does not justify a provision, unless it may be interpreted as a sign that in all probability the loan will be lost, in part or entirely.

Normally, for non-banking enterprises, the initiating of legal action to collect funds is required by the Tax Authorities in order to justify a provision. For bankers, it is admitted to a certain extent, that they rely on their experience and on their expertise concerning evaluation of risk to determine if a reserve must be constituted.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The blocking of funds abroad by foreign Exchange Control Authorities legitimates their provisioning.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Tax Authorities concerning country risks. French banks have in general taken the position that if justified for book purposes such provisions are tax deductible.

FRANCE
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A rescheduling of a debt does not necessarily mean that the loan is less doubtful. The same position seems to prevail when the debtor is a foreign state, state-owned company, or when the default of payment of the original loan was motivated by a shortage of foreign currency in the country where the debtor is located. A reserve should be reversed only if the rescheduling agreement provides real warranties. Interest which might be forgiven as part of a rescheduling is a direct loss deductible from income taxable at the normal rate.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

The Tax Authorities hold that a reserve must be deducted as soon as the risk becomes probable. The Supreme Tax Court, however, has admitted that a reserve which was posted later than this nevertheless be deducted for tax purposes.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to record interest accrued on bad debts and to provision them fully, as outlined under B.1.

FRANCE
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The only general provision which is tax deductible is the regulatory medium and long term loan provision. This provision is provided for by the tax law.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The provision is computed on long term and medium term loans (including two year loans).

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes, except when the risk is guaranteed by the French State.

5. How is the amount of the provision determined?

The total reserve may not exceed 0.5% of the eligible loans.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

FRANCE
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

The yearly allocation to the reserve may not exceed 5% of the tax basis.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

GREECE

A. General

- Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Specific loan losses give rise to write-offs - only general provision for anticipated losses may be computed.

- Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the total amount of specific write-offs. However, there must be sufficient evidence in support of the contention that the debt is bad. Where a general provision is made there is a ceiling on the amount which is charged against profits for tax purposes as described in Section C below.

- Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

It is possible where a general provision is made in accordance with tax regulations, for the amount of the provision to be in excess of what is actually required. However, this would not result in a hidden reserve as in order to qualify for tax deductibility the amount provided must be recorded in the books and shown as a reserve. It is also possible for financial statement presentation purposes, to have book reserves in excess of the amount which is tax deductible, such differences would be added back to profits when filing the annual tax return.

- Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Allowable write-offs and general provisions are deductible from profit subject to corporate tax at the rate of 28.5%.

- Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reviewed?

No.

GREECE
(continued)

B. Specific Provisions

- Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Specific provisions for anticipated losses are not tax deductible. Specific write-off will only be accepted as a tax deductible expense when every avenue for the collection of the debt (including legal action) has been exhausted and the amount written off is greater than the general provision which has been accumulated in previous years. In this case only the excess over the general provision will be accepted as a tax deductible expense with the balance being written off against the accumulated reserve.

- For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Here default of payment at due date does not constitute sufficient evidence that a debt is bad, the Tax Authorities would normally require evidence that the debtor does not have funds to meet its obligations and that all avenues for collection of the debt have been exhausted, e.g. legal action, search for assets which may be attached etc.

- Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control regulations restricting a foreign debtor from making payments would not necessarily constitute sufficient grounds for writing off the debt, especially where the debtor may pay the amount due into a blocked bank account of the creditor. The circumstances in such cases would have to be examined in determining whether the amount may be written off or not. In practice such circumstances would rarely arise for Greek banks as it is usual practice to borrow from abroad as opposed to granting foreign loans.

- Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Tax Authorities concerning country risks. As noted above the incidence of foreign loans granted by Greek banks is rare.

GREECE
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

If a loan is restructured it is unlikely that a write-off against such loan may be maintained. As noted above before a specific write-off may be made there must be prima facie evidence that the debt is uncollectible.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Although tax regulations require that expenses must be charged in the year to which they relate, in normal circumstances a write-off of a bad debt would be accepted even if it takes place in a year subsequent to the occurrence of the event giving rise to the uncollectibility, provided that it is apparent that there was a continuous effort for the collection of the amount during that period. Where a write-off is merely delayed until such time as the entity has sufficient profits against which the write-off may be charged it is possible that the Tax Authorities would disallow the write-off on the basis that it was not charged in the year to which it relates.

7. Do banks have to take into account the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks need not record interest accrued on bad debts provided that there is sufficient evidence that the debt itself is uncollectible as described in B.1. above and that the debt has been written off.

GREECE
(continued)

C. General Provisions

1. Are general provisions made in accordance with:

- specific tax legislation?
- individual agreement with the Tax Authorities?
- specific recommendations from the Banking Authorities?
- individual agreement with the Banking Authorities?
- accepted common practice?
- other?

General provisions are made in accordance with specific tax legislation and it is customary for banks in Greece to adopt this method for providing for doubtful debts as opposed to making specific provisions. The amount which may be charged against profits each year in this regard is generally 1% of the average monthly balance of loans outstanding during the year, excluding loans to or guaranteed by the Greek State, state-controlled enterprises and deposits with other banks. In the case of investment banks the rate is 2% while for real estate banks the rate is 0.2% (except for loans to hotel and tourist enterprises for which the rate is 1%).

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

All loans including those specifically mentioned above justify a general provision.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

As previously stated in A. above banks must elect either the general or specific provision approach. Only in the case where actual bad debts exceed the amount of the accumulated reserve created by the general provision each year is it possible to have a charge for specific bad debts and the general provision in any one year. In cases where a debt is regarded as specifically doubtful and interest charges have been stopped, the debt should be written off against the accumulated reserve and may not form part of the average balance on which the general provision is computed.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes except as described in C.1. above.

GREECE
(continued)

C. General Provision (continued)

5. How is the amount of the provision determined?
As described in C.1. above.
6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.
As described in C.1. above.
7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?
Only limits are as per C.1. above.
8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?
No.

HONG KONG

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?
Provisions for bad debts can only be made on a specific basis with regard to particular loans. No general reserve or provision can be made effective for tax purposes.
2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?
There is no limit to the provision which can be made, the only constraint is that the provision can only be for specific bad debts.
3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?
As only specific provisions can be made it is not possible for the deduction for tax purposes to be more than actually required and there could not therefore be a hidden reserve for tax purposes. It is more likely that prudent provision for accounting purposes would lead to a book reserve greater than the permitted tax provisions.
4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.
Yes. Specific bad debt provisions are deductible from profit before assessing Profits Tax at the standard rate (for corporations) of 16.5%.

HONG KONG
(continued)

A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Inland Revenue Department can normally reopen the computations only in respect of 6 prior years of assessment. However, if the deductibility of bad debt provisions had previously been the subject of a determination on an objection or appeal for a particular year it would not be possible for that year's computation to be reopened. If the computation for a year of assessment is reopened, any necessary adjustment would be made in that year.

HONG KONG
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

For accounting purposes a company can either write off specific bad debts or create a separate reserve for them depending on its own preferences and for tax purposes the same treatment will apply to both: the deduction will be allowed for tax purposes subject to the constraints already expressed. Having taken a tax deduction on the creation of the reserve, any of those debts are subsequently written off against the reserve, without further effect for tax purposes. Note that a provision for a doubtful debt is not tax deductible, the debt must be bad.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

In order to establish that a debt is bad it is usually necessary to show that there has been a default in payment and that reasonable steps have been taken to collect the amount due. If the debtor can be shown to be insolvent this should be sufficient. No special rules or practice apply to banks.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

If Exchange Control restrictions can be shown to prevent the repayment of the loan, even after all reasonable steps have been taken this would justify a tax provision only if the restrictions were such as to indicate possible permanent loss of the loan.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No. No special rules or practice apply to assessment of country risk either generally or for banks.

HONG KONG
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Once a provision has been made for tax purposes it would not be necessary to consider reversing the provision merely because the debt has been restructured. Any amounts of the debt repaid whether as a result of the restructuring or otherwise will be regarded as income for the year in which repayment is taken place.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Strictly speaking, debts are deductible in a year only if proved to be bad in that year. Clearly, it is not possible to make a provision prior to that year as it is a question of fact deciding when a debt becomes bad there could be circumstances when the provision can be properly made only in the following year (e.g. the year when legal proceedings have been commenced for collection of the debt).

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks can decide whether or not to accrue interest in their books on loans already provided for. If they do accrue interest it would be possible to provide immediately for the accrued interest to increase the specific debt. However, if interest is accrued on debts claimed to be irrecoverable, the Inland Revenue Department could seek to disallow the debt provision made on the basis that the banks do not in fact regard the original debt as irrecoverable.

HONG KONG
(continued)

C. General Provisions

- Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?
- List kinds of credits which may justify a general provision, and give fiscal definition of these credits.
- Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?
- Are credits which have been secured included in the basis of calculation for the general provision?
- How is the amount of the provision determined?
- If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.
- Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?
- May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

As it is not possible to make general provision for debts for tax purposes these questions are inappropriate.

IRELANDA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts must be computed on a loan-by-loan basis.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No; insofar as the provisions are specific and there are proper commercial reasons for considering their recovery doubtful there are no regulatory limits.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Specific provisions made on a loan-by-loan basis in accordance with Irish accounting practice are tax deductible and therefore no under or over provision should occur.

General provisions may be required for accounting purposes, but these are not tax deductible, thus resulting in a difference between book and tax accounting.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Provisions for bad debts are normally deductible in the trading profit and loss account in computing net profit, with an adjustment made in the taxation computation to disallow any general provisions.

Relief is therefore obtained on a specific provision at the full corporation tax rate applicable to the profits, i.e. 50%.

IRELAND
(continued)A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the account for which year are the provisions reversed?

The Tax Authorities can at any time disallow a provision that they prove was erroneously allowed. They would normally reverse the provision to profits in the accounting period of the year in which it was deducted. However, if the position had been corrected in a later accounting period by the bank; then provided there was no material effect on the tax payable considering both periods together they may leave the position unaltered.

IRELAND
(continued)

8. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Only realized losses can be written off directly. Doubtful loans must be provided for; the advances to customers being shown in the balance sheet net of such provision.

A loan is written off when every effort (including legal action) has been made to recover it without success. The loss resulting from the write-off is then charged to the provision.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Provisions will be allowed if, based on normal commercial principles, the loan is considered to be irrecoverable in whole or in part.

This may be based on the fact that default in repayment has occurred on the due date, and it is not envisaged that the borrower will be able to meet such repayment; or it may be, that due to the financial position of the borrower, it is unlikely that the loan will be repaid in full even if a default has not occurred.

For non banking enterprises, the position is normally the same although the Tax Authorities may require stronger evidence, such as the initiation of legal action to support the provision.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The blocking of funds abroad by a foreign exchange control authority has never been ruled on by the Tax Authorities, so no special rules apply. Therefore, the general rules will apply in that relief will be given if it is considered that such funds will not be recovered, and not merely that remittance is being delayed.

IRELAND
(continued)

8. Specific Provisions (continued)

The Revenue Commissioners may, on being satisfied that income cannot be remitted to the bank due to exchange control restrictions, forgo the collection of tax in relation to that income until such time as they consider that the restriction has ceased.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No position has been taken by the Tax Authorities in relation to country risk.

The normal position would apply that if the bank felt the debt were doubtful for accounts purposes then it would be tax allowable.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

The restructuring of a loan does not of itself mean that it is less doubtful and therefore the provision can be maintained. However, such restructuring may provide the bank with additional security or warranties and therefore it becomes commercially more likely that repayment will be made.

If such restructuring involves the forgoing of interest already accrued then such interest would be a direct loss and allowable as a deduction from income taxable at the normal rate.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

As soon as a debt becomes doubtful a provision should have been made during the accounting period then this would not affect the deductibility of the provision in that subsequent period.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to take into income interest accrued on bad and doubtful debts. They can however, provide in full as outlined in B.I.

IRELAND
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

No general provisions are tax deductible, therefore they are made in accordance with accounting practice.
2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

None.
3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.
4. Are credits which have been secured included in the basis of calculation for the general provision?

Not applicable.
5. How is the amount of the provision determined?

Not applicable.
6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.
7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not applicable.
8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

Not applicable.

ITALY

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

The tax deductible provisions for loan losses are computed on a global basis only.
2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

Yes, there is a ceiling on the total amount of provisions for loan losses which may be deducted for a year, (percentage of total loans outstanding at the year end, see C.6.).
3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

In recent years, because of the economic and financial difficulties faced by a number of client enterprises, the banks generally apply conservative accounting principles and therefore book a reserve in legal financial statements which exceeds the tax deductible provision.
4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Annual tax deductible provisions are normally deductible from trade income subject to corporate tax at full rate (41.34%).
5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Tax Authorities cannot disallow provisions deducted during years which are barred to tax assessment by the statute of limitation, and in particular for the taxable years for which a bank has filed a request for definite tax amnesty under a recent law.

ITALY
(continued)

8. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectible loan eventually written off?

The gross value of a loan which is considered doubtful remains unchanged and a reserve (non deductible for tax purposes) is created separately on the balance sheet. The uncollectible loan is written off when the loss becomes tax deductible (i.e. generally speaking) when the bankruptcy of the borrower has been concluded.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The Tax Authorities do not consider facts which make the risk of loan loss probable. They consider only facts which prove that the loss on a loan has been suffered, for example as a result of bankruptcy.

The evidence requirements are similar in banking business like in other sectors, but just for write-off a debt for tax purposes.

3. Do Exchange Control restrictions on the repayments of a loan or on the payment of interest by the debtor justify a tax deductible provision?

No.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Not applicable.

ITALY
(continued)

8. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is a relevant factor for the deductibility of write-off of a loan.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to record interest accrued on bad debts and have to provision them, on a specific basis, for the full amount of the interest.

ITALY
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are made in accordance with specific tax legislation as indicated in A.2. above.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Credits on which a general provision may be computed are loans toward the clients, excluding loans to other banks, interbank transactions etc.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No specific provision exists and therefore all loans are included in the basis of calculation of the general provisions.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes, also credits which have been secured are included in the basis of calculation for the general provision.

5. How is the amount of the provision determined?

The annual provision is computed in the amount of 0.5% of the total loans outstanding at the balance sheet date (excluding interbank transactions). Such annual charges to operations are reduced to 0.2% when the allowance has reached 2% of the outstanding loans, and is no longer applicable when the allowance has reached 3% of the outstanding loans.

The bad debt deduction for overdue interest (interessi di mora) may equal the amount of such interest credited to profit and loss account.

ITALY
(continued)

C. General Provisions (continued)

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

The above rates are fixed by law.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

See point 5 above.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

JAPAN

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis (general provision), or are both systems combined?

Tax deductible provisions for loan losses are computed on both a loan-by-loan basis and a global basis (general provision).

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There are two types of provision for loan losses computed on a loan-by-loan basis: special reserve for specific loans identified as bad or doubtful and reserve for specific overseas receivables. The former is for losses due to other than country risks and the latter is for losses due to country risks.

There is no ceiling on special reserve for specific loans identified as bad or doubtful which may be deducted.

Reserve for specific overseas receivables was introduced as of March 31, 1983 and is not tax deductible at present. (It is possible that it will become tax deductible in the near future).

There is a ceiling on general provision for loan losses, which is the higher of the following:

- A stipulated percentage (currently 0.3%) of total loans (as defined by tax laws) outstanding at the balance sheet date.
- Total loans (as defined by tax laws) outstanding at the balance sheet date multiplied by the average loan loss ratio for the three years preceding the reporting year.

JAPAN
(continued)

A. General (continued)

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Japanese bank accounting standards promulgated by the Ministry of Finance (a) require banks to establish special reserve for specific loans identified as bad or doubtful at the full amount deductible for tax purposes even if it exceeds the amount needed for accounting purposes and (b) encourage banks to set up such reserve exceeding the amount deductible for tax purposes if needed for accounting purposes. In the former case, the hidden reserve exceeding the amount needed for accounting purposes constitutes a hidden reserve.

Although reserve for specific overseas receivables is computed on a loan-by-loan basis, the reserve must not be less than 1% or more than 3% of the aggregate "applicable receivables" at the balance sheet date. Consequently, reserve for specific overseas receivables may be less than or exceed the amount required for accounting purposes. The excess constitutes a hidden reserve.

Japanese bank accounting standards, in principle, require banks to maintain general reserve for loan losses at the full amount deductible for tax purposes - neither less nor more than that. Due to certain transit measures, however, general reserve for loan losses exceeds the tax deductible limit at some banks. General reserve for loan losses can be less or more than the amount needed for accounting purposes but is generally believed to exceed the amount needed for accounting purposes. If that is so, the excess constitutes a hidden reserve.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deductible from the basis of assessment of corporate tax at the full rate.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities cannot disallow provisions deducted during years which are barred to auditing by the statute of limitation.

JAPAN
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The gross value of a loan which is considered doubtful remains unchanged, with a reserve being created separately on the balance sheet. When an event(s) stipulated in tax laws has occurred with respect to the borrower, the uncollectible loan is written off with offset to the reserve.

Write-off is made for the following loans:

- (a) Loans discharged due to determination of composition under the Composition Act.
- (b) Loans discharged due to determination at the creditors' meeting or through mediation by third parties such as administrative organs, financial institutions, etc.
- (c) Loans discharged and so advised to the borrower in writing.
- (d) Loans, the unpaid balance of which is deemed as totally uncollectible in consideration of the borrower's state of affairs (bankruptcy, composition, seizure, liquidation, death, missing, liabilities exceeding assets, natural disaster, sudden change of economy and other similar situations

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Upon application by a bank, the bank inspectors of the Ministry of Finance review evidence submitted by the bank and issue a certificate of loss to the bank. There is an arrangement between the bank inspectors and the Tax Authorities whereby such certificate of loss should be normally accepted by the Tax Authorities as the final evidence of loss.

Evidence requirements are not looser in the banking business than in other sectors.

JAPAN
(continued)

B. Specific Provisions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restrictions on the repayment of a loan or on the payment of interest by the debtor do not justify a tax deductible provision.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

See third paragraph under item A.2.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A provision previously made with respect to a loan can be maintained even if that loan has been restructured subsequently.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

A provision will be disallowed if not deducted during the year of occurrence of the event which makes the loss probable.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks discontinue accruing interest income on provisioned loans. Provision is made for interest income previously accrued.

JAPAN
(continued)

General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

See the third paragraph under item A.3.
2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Credits other than bank deposits, investment bonds, and commitments and contingencies justify a general provision.
3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

A credit which has been fully provisioned on a specific basis is not included in the basis of calculation for the general provision. If not fully provisioned, unprovisioned portion of such credit is included in the basis of calculation for the general provision.
4. Are credits which have been secured included in the basis of calculation for the general provision?

Secured credits, excluding those for which deposits with the lending bank have been legally pledged, are included in the basis of calculation for the general provision.
5. How is the amount of the provision determined?
6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

5 and 6. See the fourth paragraph under item A.2.

JAPAN
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

General reserve is computed at every balance sheet date in accordance with the formula described in the fourth paragraph under item A.2. The existing general reserve is adjusted to the newly computed general reserve with effect to the profit and loss account.
8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

See third paragraph under item A.3.

LUXEMBOURGA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provisions for loan losses must be computed on a case-by-case basis. However, banks are permitted to deduct a general reserve computed on their non-secured credit portfolio.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the total amount of provision for loan losses which may be deducted in a particular year. The general reserve is, however, deductible for tax purposes only to the extent of the permissible percentages.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

A provision set up to meet a specific or foreseeable risk is normally tax deductible. However, a hidden reserve may result from the setting-up of a general reserve on non-secured loans for the sole purpose of reducing the bank's tax liability. On the other hand, a provision set up to meet an unspecified contingency will not be tax deductible and will result in a discrepancy between book and tax profits.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deducted from the trading profit subject to corporate tax at full rate.

LUXEMBOURG
(continued)A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities may disallow provisions deducted during years which are barred to auditing by the statute of limitation. By virtue of the comparison of net wealth at the beginning of the year and at the end of that year, the Tax Authorities are able to assess any provisions which are no longer considered necessary to cover losses or charges, notwithstanding the year in which the provisions were made or the fact that the provision was spontaneously reversed in a later year.

LUXEMBOURG
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Debts which are unrecoverable must be written off, whilst debts which become totally or partially doubtful must be valued at their estimated realisable value. (Estimates should be based on facts that exist at the balance sheet date which were unknown at the time the provision was made). This reduction in value can be achieved either through a write-down of the debt or through a specific bad debt provision.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Default of payment at the due date may justify a write-down or a provision as it will be seen as a sign that at least some part of the loan will be lost. There is no major difference in the evaluation of debts for tax purposes between non-banking enterprises and banks even though to a certain extent, it is admitted that banks have more experience and expertise in this field.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restrictions on the repayment of a loan or on the payment of interest by the debtor constitute a valid argument for making a provision.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

The Tax Authorities, under pressure from the banks, have accepted that a provision be set aside for loans made to countries whose credit risk is high. The tax deductible provision may amount to 15% of the outstanding balance of the loan.

LUXEMBOURG
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

As a rescheduling of a debt does not necessarily mean that the loan is less doubtful, the specific provision indicated under B.4. above can be maintained until there exist clear signs that the loan will be repaid.

6. Is timing a relevant factor vis-à-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is a relevant factor vis-à-vis the tax deductibility of a provision for loan losses as the Tax Authorities maintain that a reserve must be deducted as soon as the risk becomes probable. As it is always a question of facts and circumstances, a taxpayer may demonstrate that those facts and circumstances only occurred during a given year and were not envisaged in the previous year.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to record interest accrued on bad debts and to fully provide for them as outlined under B.1.

1. GENERAL PROVISIONS
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The only general provision which is tax deductible is the statutory provision on unsecured loans. This provision is provided for by tax law and is certified for correctness by the Banking Authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The general provision is computed as follows:

- 1.5% of the following captions:
 - 1312 Negotiable finance bills
 - 1314 Non-negotiable finance bills
 - 1372 Unsecured overdrafts and loans up to one month
 - 1392 Unsecured loans and advances over one month
- 1.0% of the following captions:
 - 1313 Endorsable commercial bills
 - 1314 Bank acceptances
 - 1317 Other bills
 - 135 Instalment loans (other than mortgage loans included in line 1322)
- 1.0% of loans and advances secured by ship mortgages included in lines 137 and 139. The amount of these must however never exceed 20% of the total provision.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Credits, for which there is a specific provision must be excluded from calculation of the general provision.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Secured credits must also be excluded from the general provision calculation.

1. GENERAL PROVISIONS
(continued)

C. General Provisions (continued)

5. How is the amount of the provision determined?

See C.2.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

See C.2.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

The yearly increase or decrease of the general provision is equal to the difference between the closing balance and the opening recorded balance of that provision. A decrease of the provision would become taxable for that year.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

General provision, deductible for tax purposes, forms part of equity for banking purposes.

MALAYSIA

A. General

- Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provisions for loan losses must be in respect of specific loans (i.e. loan-by-loan basis) before they are allowed for tax deduction. The Tax Authorities may require evidence that attempts have been made to recover the loans and have failed.

- Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No.

- Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

The tax deductible provisions for loan losses can be less but not more than the amount actually needed (i.e. provisions for loan losses (both specific and general) as shown in the accounts) as only specific provisions are tax deductible while general provisions are not. Therefore a hidden reserve due to excess fiscal provision would not occur but a book reserve exceeding the tax deductible provision could arise.

- Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions for loan losses are set off against business income which is subject to the full tax rate.

- Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Not applicable.

MALAYSIA
(continued)

B. Specific Provisions

- Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

There is no specific requirement for the treatment as both methods have the same result on the profit and loss account. In practice, a provision is made if there is still a possibility of collection while the loan is written off if it is certain that it would not be recovered such as the bankruptcy of the borrower etc.

For tax purposes, a loan written-off is normally allowed for deduction without such quavering by the Tax Authorities while recovery action has to be substantiated in the case of the provision for loan losses.

- For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loss less probable? Are evidence requirements looser in the banking business than in other sectors?

For a provision for loan losses to be allowed for deduction, evidence of attempts to collect the debt and failure to do so is normally required by the Tax Authorities. In practice, the evidence requirements in the banking business are less stringent compared to those in other sectors.

- Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restriction on the repayment of a loan can justify a tax deductible provision provided they are preceded by attempts in recovering it. Provisions made under such circumstances are normally allowed by the Tax Authorities.

- Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

Not applicable. Malaysian banks generally do not lend to overseas borrowers.

MALAYSIA
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

The provision will have to be written back and assessed if the restructuring of the loan ensures recoverability for the bank.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Regardless of when the recovery of the loan becomes doubtful, the provision for loan losses is only allowed during the year in which the provision is made and there is evidence of non-recovery.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks do have to accrue for interest on provisioned loans. However, it is the general practice to credit this interest to an interest in suspense account which is treated as a specific provision account.

MALAYSIA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
- individual agreement with the Tax Authorities?
- specific recommendations from the Banking Authorities?
- individual agreement with the Banking Authorities?
- accepted common practice?
- other?

General provisions, if any, are made in accordance with accepted common practice with recommendations from the Central Bank but are not allowed for tax deduction.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

None.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Not applicable.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Not applicable.

5. How is the amount of the provision determined?

Not applicable.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not applicable.

MALAYSIA
(continued)

C. General Provisions (continued)

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

General provisions are not deductible and have to be set-off against the loan account in the balance sheet.

MEXICO

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Tax deductible provisions are computed on a loan-by-loan basis. Loan losses should be approved by the Banking Commission for deduction.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the amount of provisions for loan losses. However, provisions in all cases should be approved by the Banking Commission for either book or taxable deduction.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Commonly, provisions deducted for tax purposes are similar than for book purposes. However, it could be for a specific period depending on the time taken by the Banking Commission to authorize the tax deduction of the loss.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deductible at full rate in accordance with the corporate tax law.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

As indicated before, provisions are always deducted under specific authorization from the Banking Commission which in fact represents the Tax Authorities. A disallowance from prior years would depend on a decision taken after the approval and the reverse would be recorded in the year of such disallowance.

MEXICO
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectible loan eventually written off?

The gross value of a loan remains unchanged and a separate reserve is created. The uncollectible loan is written off when the Banking Commission issues the authorization based on the evidence supporting the request for writing-off. Sometimes the Commission requests the write-off without a previous request from the Bank supported on its own knowledge of a particular case.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Acceptable evidence of a probable risk of loan loss is mainly represented by borrowers' poor financial condition, lack of adequate guarantees for covering principal and inability to pay interests on time.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restriction could not be the unique factor to justify a loss provision, but it could be one of the main factors.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

The position of both the Tax Authorities and the banks is to take the risk of the specific borrower, based on the conditions of the country, if it represents risk.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

If a loan is restructured, a provision for loss would be reversed. Further, it would be difficult to make a provision for a loan with probabilities of being restructured or at least, accepted by the Banking Commission.

MEXICO
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is not a relevant factor for the tax deductibility of a loss provision. However, the deductibility of a loss provision could be disallowed if, finally, the Tax Authorities determined that there is not enough evidence to support the tax loss.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Interests on provisioned loans are not taken into income. Normally, they are not accrued.

MEXICO
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
 - specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are not common in Mexico. If recorded, they are made in accordance with specific recommendations from the Banking Commission.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Credits which may justify a general provision are those related to a specific economic sector like agriculture or others that government tries to support.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

A general provision recommended by the Banking Commission should be always based on specific credits depending upon the portfolio of the particular bank.

4. Are credits which have been secured included in the basis of calculation for the general provision?

No.

5. How is the amount of the provision determined?

As indicated in C.3.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

MEXICO
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not applicable.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

Any general provisions would always be deducted from income.

THE NETHERLANDSA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provisions for loan losses can be computed on a loan-by-loan basis, on a global basis or indeed by a combination of both methods.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There are no ceilings on the total amount of the provisions for loan losses which may be deducted in any given year. Although certain tax inspectors in the past to have imposed certain limits (which were approximately equal to 1% of total loans), these are no longer followed and significantly higher provisions - as a result of the poor economic situation - have been permitted in recent years.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Provisions made, in accordance with Dutch accounting principles, on a case-by-case basis are tax deductible. More often than not, the commercial provision will exceed the tax provision, thus giving rise to a form of hidden reserve. Under Article 329 (3) of Book 2 of the Civil Code, a provision may be created and included under the heading "creditors", to cover the general risks inherent in the granting of credit facilities and other banking activities. This provision for general contingencies (the VAR "voorziening van algemene risico's") is mainly charged with appropriations to the provision for accounts receivable. This provision is not "per se" tax deductible, thus resulting in a difference between book and tax accounting.

THE NETHERLANDS
(continued)A. General (continued)

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions are always deductible - from the basis of assessment for corporate tax - at the full rate (i.e. 48%).

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

If a particular year of assessment is still open to examination by the Tax Authorities, there is always the possibility of a tax inspector (or state auditor) challenging the size of the provision and seeking to disallow a part or all of it.

A final assessment may not be issued later than 3 years after the end of book year concerned. If an extension for filing the tax return was allowed, the extension period is added to this 3 year period.

THE NETHERLANDS
(continued)

8. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectible loan eventually written off?

Doubtful loans cannot be written off directly as long as the loss has not been realized. The appropriation to the provision for accounts receivable is charged to the provision for general contingencies - this is part of the creditor's caption on the liability side of the balance sheet. A loan is written off by reducing the provision for general contingencies and the asset amount simultaneously - this only takes place though when every chance of recovery has been exhausted and the amount is considered uncollectible.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Debtors are valued collectively, according to certain statistical methods which take into account:

- (a) arrears
- (b) historical loss figures
- (c) prevailing economic conditions
- (d) the position from industry to industry

There is no requirement that a bank must wait - before providing - for a specific default in payment, although, this would, in most instances, signify a need for a provision.

The Tax Authorities recognize that banks are more experienced in evaluating the risk vis-a-vis the making of loans and in determining the size of a reserve that may be required. Nevertheless, they will themselves attempt to judge whether the increase in the provision can be justified by reference to that particular bank's loan portfolio.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The blocking of funds abroad by foreign exchange control authorities is a factor that may be taken into account in justifying a tax deductible provision.

THE NETHERLANDS
(continued)

8. Specific Provisions (continued)

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position, as yet, has been taken by the Tax Authorities concerning "country risks". However, the Netherlands Bank is monitoring a bank's solvency ratios is increasingly insisting on banks providing for a specific percentage against certain "country loans". The tax inspectorate, although not required to, is tending to take account of such requirements.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A rescheduling of a loan does not mean that it is less doubtful; indeed, in many instances, it will result in a write-off of interest previously charged, thus warranting a tax deductible write-off if not already taken.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

In principle, a provision for a bad debt should be created as soon as the bank recognizes the possibility of a loss being incurred. If the Tax Authorities could prove that a bank had purposely failed to provide against a loan in an earlier year (when they should have done), they could disallow a specific provision in a subsequent year. However, if the debt were ultimately written off, this would be accepted in that year by the Tax Authorities.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Generally speaking, a bank must first record the interest income accrued on a loan before (simultaneously) providing for its possible loss. There are, though exceptions to this rule as regards certain hire purchase transactions, where the taxation of the interest income can be deferred until the instalments received have exceeded the nominal value of the loan.

THE NETHERLANDS
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The Supreme Court in 1956 expressed the view that a general valuation of outstanding debtors was permissible. In the case in point, the provision had been calculated partially on a case-by-case basis analysis and on an overall percentage basis.

Although, the matter is very much one for individual agreement with the Tax Authorities, current practice appears to be to allow a general provision equal to 1 1/2% of all loans (after excluding those that are secured, made to government institutions and other banks) for which there is no specific provision.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

There is no Dutch tax legislation specifying for which types of credits a general provision may be justified: as commented above, the Tax Authorities are reluctant - at present - to permit general provisions for government institutions and inter-bank loans.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Credits which have been provided for on a specific basis are excluded in calculating a general provision.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Generally speaking, the Tax Authorities would seek to exclude those debts which are secured; however, this has to be evaluated in the light of the effectiveness of that security at the time of creating such a provision.

THE NETHERLANDS
(continued)

C. General Provisions (continued)

5. How is the amount of the provision determined?

This is a matter for individual negotiation with the Tax Authorities; however, see point 1 above.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

There are no limits prescribed under Dutch Law concerning the amount of the annual increase of the general reserve.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

NORWAY

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Tax deductible provisions for loan losses are computed as a general provision, based on the total outstanding amount as per December 31 each year.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

Banks may take up to 1% deduction annually as en-bloc provisions for losses. If the bank's actual loss exceeds 1% in a single year, the bank may write off the whole loss provided the loss is charged to the en-bloc offset account. The 1% is based upon the bank's outstanding amounts as per December 31.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

The amount that is being deducted for tax purposes will generally be more than what is actually needed. Consequently a hidden reserve will often be on the books of the bank. The loss provision for accounting and tax purposes will generally be the same.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

It will always be deductible at full corporate tax rate.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

No.

NORWAY
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The gross value of a loan which is considered doubtful remains unchanged with a reserve being created separately on the balance sheet. The uncollectible loan is written off when it is finally stated that it is uncollectible.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The objective facts that are required will generally be a moratorium, bankruptcy or liquidation. The requirements are not lower in the banking business than in other sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

No.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

Not known.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

This is not likely to occur since normally general provisions will be applied.

NORWAY
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

It might be. If the deduction is not claimed in the year when the loss is suffered, it cannot normally be claimed later.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

No.

NORWAY
(continued)

C. General Provisions

1. Are general provisions made in accordance with:

- specific tax legislation?
- individual agreement with the Tax Authorities?
- specific recommendations from the Banking Authorities?
- individual agreement with the Banking Authorities?
- accepted common practice?
- other?

General provisions are made with basis in the General Tax Act as recommended by the Tax Authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The basis for the general provision will be: line of credit, promissory notes and mortgage loans.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Yes.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes.

5. How is the amount of the provision determined?

By a percentage at year's end of credits mentioned under C.2.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Annual rate is 1%. No differentiation depending upon kind of credit.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not any restriction upon the 1% annual provision, but the total reserve may not exceed 3% of applicable credit.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

PORTUGALA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Both systems are used in combination.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

Theoretically there is no ceiling for the provision, but in practice most banks will probably provide for the maximum allowed for taxation purposes.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Yes, there could be a hidden reserve. Although the banks must account for provisions in excess of the taxation allowable maximum in a separate account in the books, there is no requirement to disclose the amount in the published accounts and may be shown net of the credits to which they refer. The tax allowable maximum will normally be shown on the face of the balance sheet. However, such a hidden reserve would be fully disclosed in the Central Bank returns.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Yes.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities may not disallow provisions deducted during the year which are outside the statute of limitations period (five years).

PORTUGAL
(continued)B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The gross value of a loan which is considered doubtful remain unchanged and a reserve is created separately on the balance sheet. The uncollectible loan will be written off against the provision when judgement is awarded in the courts.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The Tax Authorities accept provisions up to the allowable maximum based on management experience and the normal conditions which would allow for a debt to be considered doubtful. The evidence requirements are the same as in other industry sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Yes, but within the terms described above, i.e. up to the tax allowable maximum until the results of legal action are known.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

The Tax Authorities have not taken any specific position on the relevance of country risk to justify a provision. Portuguese banks have only recently entered the international banking market and the general policy to country risk provision are unknown as yet.

PORTUGAL
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Yes.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing is not a relevant factor vis-a-vis the tax deductibility of a provision per loan losses.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Interest is normally paid by borrowers at the front end. Provision would be made on those rare occasions when interest was paid in arrears and overdue, but the latter situation would only occur with triple credit rated customers.

PORTUGAL
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are made in accordance with specific tax legislation - see above and recommendations from the banking authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

All credits justify a general provision short, medium and long, acceptances and guarantees.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes.

5. How is the amount of the provision determined?

Usually 3% (tax allowable maximum) of total of all credits not specifically considered doubtful.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Rates fixed by tax law for the allowable maximum as in C.5. above. Same rates for all credits. Tax allowable maximum can be exceeded if the bank so desires (see A.3. above).

PORTUGAL
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No limits except for tax allowable purposes.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

SINGAPORE

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

The Singapore Tax Authority considers each claim for the deduction of loan losses on a case-by-case basis. General provisions made are not tax deductible.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the total amount of loan losses which may be deducted for a year.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Not all specific provisions for doubtful debts made in the accounts will qualify for deduction. The Singapore Tax Authority is very strict in its application and will only allow a deduction if the Comptroller is satisfied that the debt is indeed doubtful, i.e. action must have been taken to recover the debts and in spite of all the steps taken, the possibility of recovery must be remote. He does not allow a deduction merely because the provision was made at the request of the Monetary Authority of Singapore. A deduction will not be allowed until action has been taken to realise any available security, including personal guarantees.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

When approved, specific provisions are deductible at the full corporate tax rate. In Singapore, the income of banks is subject to tax at either 10% or 40%. Relief in respect of deductible provisions is available at the same rate of that applicable to the income derived from the loan in question.

SINGAPORE
(continued)

A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

There is no tax audit in Singapore, but every computation is checked by the Tax Authority. Specific provisions are allowed as a deduction in the same year, provided the Tax Authority is satisfied that the debts are doubtful. Subsequently, should there be any recovery of earlier provisions, they are treated as taxable receipts in the year of recovery.

SINGAPORE
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

In the banks' accounting records, provision for doubtful debts and loans are kept separately, but for presentation in the balance sheet, this provision is netted off against the relevant asset. Management may use its discretion in deciding when to make the final write-off.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The onus of proving that a debt is unlikely to be recoverable lies with the bank. The Tax Authority does not treat banks more leniently than other sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The Singapore Tax Authority allows provisions which result from exchange control restrictions, only if it seems probable that the bank will suffer a permanent loss.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been taken by the Singapore Tax Authority concerning country risk, but we expect their attitude will become clearer when tax computations based on 1982 accounts are submitted.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Together with other indicators, such as interest payment default and principal default, the failure of rescheduling negotiations may cause the Monetary Authority of Singapore to insist that a provision be made either fully or partially. The Tax Authority will not necessarily take the same view.

SINGAPORE
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Deductibility will not be forfeited merely because of delay in making a claim.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Generally, banks do not take into income interest accrued, but not received on doubtful loans. But if the provision against the loan is disallowed by the Singapore Tax Authority, the interest accrued on that loan, although not recognized as income in the accounts, will be brought into charge for income tax purposes.

SINGAPORE
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are neither required nor permitted for tax purposes. The Monetary Authority of Singapore may request individual banks to make a general provision, and they will usually encourage banks to do so if in accordance with the bank's own policy. In practice, local banks usually carry hidden general provision; branches of foreign banks do not.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Since general provisions are not recognized for tax purposes, there is no fiscal definition.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

There is no common policy for the calculation of general provisions.

4. Are credits which have been secured included in the basis of calculation for the general provision?

This will depend on the policy of the individual bank.

5. How is the amount of the provision determined?

This will depend on the policy of the individual bank.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable. Even if the general provision is made at the request of the Monetary Authority of Singapore, the percentage varies, depending on the circumstances of each bank.

SINGAPORE
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

General provisions are not allowed for tax purposes. For accounting purposes, the Monetary Authority may, and usually does, give approval for general provisions to be concealed in the balance sheet by inclusion in liabilities or by deduction from assets.

SPAIN

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provision for bad debts must be computed under two different alternatives:

- (a) on a case-by-case basis (in accordance with a timing schedule and certain legally established percentages) or
(b) on a global basis (as a percentage of the pending assets and guarantees at the time of computation, and following a timing schedule).

The highest amount resulting from the above two alternatives will be that to be necessarily allocated to the provision in accordance with the Bank of Spain rules which are applicable with certain adjustments for tax purposes.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

The total amount of the provision to be made on a case-by-case basis will depend on the period of time the loan has been in the doubtful collection situation and on the recoverability of the loan in accordance with Bank of Spain rules. However, for tax purposes, the timing schedule may be accelerated.

Please note that for certain specific assets (certain guaranteed loans, government loans, loans to political parties and trade unions, loans to affiliates, etc.), no provision is allowed taxwise unless very specific conditions are met and regardless of the fact that for Bank of Spain purposes only certain of said loans are excluded from the computation.

As regards the provision made on a global basis, only 1.5% as a maximum of the pending qualifying assets including guarantees at year end but excluding those guaranteed by rights in rem will be considered as deductible.

SPAIN
(continued)

A. General (continued)

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would act ally be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

Yes. In the case of the 1.5% general global provision, it may very well happen that the amount provided for is higher than the amount required (i.e. we have cases where the bank has no loan losses and nevertheless has created the provision as required by Bank of Spain rules). The contrary may also happen especially with regards to such loans for which the Bank of Spain requires a provision which is not tax deductible as indicated in A.2. above.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Yes.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Provisions as well as any other expenses deducted during years barred to auditing by the statute of limitation cannot be disallowed by the Tax Authorities.

SPAIN
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Normally, for debts where there is a risk of not being collected, a reserve for bad debts has to be created according to certain percentages depending on the time elapsed since the doubtful collection situation starts. The gross value of the loan remains in principle unchanged.

However, in the case of those debts where the debtor is in a bankrupt situation or in any other notorious and not recoverable insolvency situation, as well as those remaining debts unpaid for three years or more since they were considered as of doubtful collection, these may be immediately written off with application of the provision established therefor.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

As regards banks, as we have mentioned above, those provisions made under Bank of Spain regulations are expressly considered as tax deductible. According to these regulations, the circumstances under which a loan is considered doubtful are the following:

- (a) When the debtor is bankrupt, under a suspension of payments procedure, or in a similar insolvency situation.
- (b) When the debt has been judicially claimed or the debtor has started legal proceedings the solution of which will affect the payment.
- (c) When the debtor has not paid within six months since the debts were due (three months for banks).

SPAIN
(continued)

B. Specific Restrictions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Although this situation is not expressly contemplated under Spanish legislation, we believe that if foreign exchange control authorities were to disallow the repayment of a loan or the payment of interest, this circumstance could be considered a reasonable basis to justify the doubtfulness of the receivable and the necessity of creating a provision therefor, especially in view of Bank of Spain rules in this connection.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

No specific position has been officially taken by the Tax Authorities concerning country risks although the Bank of Spain has been considering the necessity of adopting special measures for loans granted to countries with an unstable political and economic situation.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

When the rescheduling implies a renewal of the loan or when new financial facilities are given to the debtor, any provision made thereon will have to be reversed as, for tax purposes, in such a case the debtor is no more considered to be in a doubtful collection situation.

This will not be the case, however, if the rescheduling of the loan takes place within a suspension of payments or any other similar *de facto* procedure. Therefore, in these cases, the provision may be maintained. Also, in this case, any loss arising from interest forgiven as a part of the rescheduling will be tax deductible to the extent that it is not covered by the provision.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Yes.

SPAIN
(continued)

B. Specific Provisions (continued)

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

As a general rule, interest accrued on bad debts, except in those cases where the account has been officially closed and the unpaid amounts claimed from the debtor through a Notary Public, will have to be taken into income although it can be provided for.

However, since under Bank of Spain regulations income recognition should be discontinued as soon as a debt is classified as of doubtful collection (futhermore, in such a case all unpaid interest, commissions and expenses at the time of the classification are also to be considered as of doubtful collection and duly provided for), there are certain arguments to defend that those banks following Bank of Spain regulations in this connection should not have any major problems.

SPAIN
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

The possibility of making a general provision is contemplated both in specific tax legislation (Company Income Tax Regulations) and in specific Bank of Spain regulations.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

In principle, the general provision is computed on all credits and guarantees excluding only those secured by rights in rem as required by Bank of Spain regulations.

However, as previously indicated, tax regulations are slightly different from Bank of Spain regulations to the extent that they do not allow taxwise provisions made on certain assets such as credits to affiliates, non-profit organizations, trade unions, political parties, etc., unless certain conditions are met. It is not clear yet (the Order was published in April 1983) whether the disallowance will apply only to specific provisions made on them or whether it will apply to both types of provisions.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Yes. It should be remembered that notwithstanding its acceptability for tax purposes, the general provision is merely intended to be the strict minimum reserve required for Bank of Spain purposes (if the specific provision alternatively computed is higher, this last will have to be made instead). Because of it, all credits including those already provided for will have to be included in the computation.

SPAIN
(continued)

C. General Provisions (continued)

4. Are credits which have been secured included in the basis of calculation for the general provision?

Yes, except for debts guaranteed by mortgages, pledges or similar guarantees over specific assets provided that the real value of such guarantees is maintained.

5. How is the amount of the provision determined?

The amount of the provision is determined using as a basis all qualifying credits and guarantees as explained in C.2. above pending at the end of each six month period and applying them the pertinent percentage.

6. If it is by application of rate as fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

The rate applicable to determine the provision is 1.5%. However, it is applied in accordance with a timing schedule which increases by 10% every six months starting in June 1982 and has to be completed by December 1986 when the full 1.5% provision has to be reached (for tax purposes the calendar year may be accelerated).

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

The only limit applicable is that the balance of the provision may not exceed 1.5%.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

SWITZERLANDA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

In principle, provisions for loan losses are computed either on a global basis (general provision) or, less frequently, on a loan-by-loan basis (specific provision). A combination of the two methods (general provision plus specific provision for highly exposed cases) is the rare exception and should be discussed first with the Tax Authorities before implementation.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

Specific provisions are not subject to limitation in amount. However, the taxpayer is expected to establish the necessary and reasonable character of the established provision. General provisions normally represent 1 - 5% of the total loan portfolio - excluding amounts due from other banks. Within those limits, which represent safe havens, the taxpayer is not required to furnish proof of the reasonableness of the provision established.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

(a) Specific Provisions

Specific provisions are established in order to reflect with a high degree of precision the potential loss incurred in connection with a specific risk asset. It is therefore unlikely that the establishment of specific provisions results in a hidden reserve. Also, there is seldom any divergence between accounting and tax regulations in terms of asset valuation.

(b) General Provisions

By its very nature, a general provision is susceptible to resulting in a hidden reserve. This is not otherwise problematic, since the establishment of hidden reserves is acceptable both for tax purposes (see above) and under conservative Swiss accounting principles.

SWITZERLAND
(continued)A. General (continued)(c) Inadequate Provisions

Under both methods (general and specific provisions), it is possible that a bank is inadequately covered in view of its total exposure to loan losses. Such a situation is clearly in conflict with Swiss accounting principles and should never occur. In all likelihood, the bank auditors would have to qualify their report and the Banking Commission would require the bank to take immediate action. If such corrective action is taken, the additional provision established (which now conforms with Swiss accounting principles) would be tax deductible.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Provisions for loan losses are deductible from trade income subject to normal Swiss federal and cantonal tax rates.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Upon assessing the taxpayer, the Tax Authorities have the right (and the duty) to review whether the provisions for loan losses are proper. With regard to the general provision the Tax Authorities would typically have to determine whether or not the provision taken is well within the percentage limits described above. With regard to the specific provision, the Tax Authorities would typically have to satisfy themselves as to the reasonableness of the provision taken. Clearly, the Tax Authorities can undertake such a review each year, without being bound by a determination made during earlier years. For example, they may consider that a specific loan loss provision established in 1980, although it was fully justified in that year, given the prevailing facts and circumstances at that time, is no longer required in 1982 (borrower again solvent) with the result that the excess provision must be brought back to income in 1982.

However, once such review procedure is completed for the assessment of the taxes due during the current year, the assessment becomes final within 30 days. Any subsequent disallowances on a retroactive basis would be barred by statute of limitation (except in tax fraud cases).

SWITZERLAND
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

According to Swiss bank accounting principles, provisions for loan losses can be reflected, at the option of the bank, either separately as a reserve on the liability side of the balance sheet (under the caption "autres passifs"/"sonstige Passiven") or as a deduction from the risk asset (netting).

The final write-off is generally booked at the time the bank considers that the chances of collecting have disappeared (for example, bankruptcy of the customer).

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Acceptable evidence is represented by, but not limited to, the following objective facts:

- (a) aging of delinquent loans
- (b) borrower is delinquent in the payment of interest
- (c) transfer risks of foreign currency loans
- (d) prior year loss experience
- (e) business press
- (f) confidential reports by business information agencies.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restrictions on the repayment of a loan or on the payment of interest by the debtor may justify a deductible provision.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

For tax purposes, country risk constitutes sufficient justification for creating a provision. Under Swiss bank accounting principles, banks are required to create appropriate provisions with regard to country risk.

SWITZERLAND
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Under Swiss bank accounting principles, a specific provision must be dissolved as soon as the quality of the loan is restored. The same principle applies for Swiss tax purposes.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Normally, a provision must be created as soon as the risk is perceived by management under objective standards. If, for any reason whatsoever, the bank arbitrarily decides to recognize the charge to income at some later point in time, such charge would be regarded as inconsistent with sound bank accounting principles and, as a result, would be held non-deductible.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to record interest accrued on bad debts and must provide for them immediately as set out under B-1.

SWITZERLAND
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are made in accordance with current practice of the Tax Authorities.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The following risk assets represent the basis for computation of the provision and are usually accepted by the Tax Authorities:

- (a) bills of exchange and money market papers
- (b) customers' current accounts
- (c) loans and advances (secured/unsecured)
- (d) securities.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Specific risk assets on which a specific provision has been made cannot be included in the basis of calculation for the general provision.

4. Are credits which have been secured included in the basis of calculation for the general provision?

The general provision may include secured loans.

5. How is the amount of the provision determined?

The amount of the general provision normally represents 3 - 6% of the risk assets as set out under C.2.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

See C.5.

SWITZERLAND
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

There is no limit applicable to the yearly increase of the general provision. However, in situations where an existing bank that did not previously have any general provision decides to do so, it would be unrealistic to establish such general provision in one single year. In these situations, current practice generally requires establishing the norm of 3 - 6% over a period of 3 - 6 years.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

According to Swiss banking law, the bank's equity includes hidden reserves established in accordance with Swiss accounting principles, provided they are taxed. General provisions established within the limits set out under A.1. are normally tax deductible. As a result, they are not included in the bank's equity.

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UNITED KINGDOMA. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Only specific provisions are deductible for U.K. taxation purposes. These must be calculated on a loan-by-loan basis.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the total amount of provision for losses which may be deducted in any particular year. All deductible provisions have to be justifiable within the terms of that particular loan.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

General provisions are not deductible. Thus the provisions made in the accounts of the entity will exceed the tax deductible provisions to the extent that the entity has made general provisions.

All specific provisions should be deductible for taxation purposes where U.K. accounting principles have been adopted. However it is possible that where provisions have been established on the basis of excessively conservative accounting policies that the specific provisions may also be treated as non-deductible and thus exceed the tax deductible provisions.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

An increase in a specific provision is treated as a trading expense and thus is deductible from the basis of assessment of corporation tax at full rate.

UNITED KINGDOM
(continued)A. General (continued)

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

All tax computations have to be specifically agreed with the Inspector of Taxes. In the case of a dispute the extent of any provision will be decided on the facts available at the time when the provision was made. A subsequent change in the facts does not enable the Inspector to change his decision. Provisions allowable for tax purposes must be reviewed annually. The subsequent reversal or reduction of a provision which has been tax deductible will be treated as taxable income in the year in which it is reversed, not in the year it was originally made.

UNITED KINGDOM
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

U.K. accounting policy distinguishes between a "provision" which is "any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets" and a "reserve" which is an amount which "is in excess of that which in the opinion of the directors is reasonably necessary for the purposes, the excess shall be treated as a reserve and not a provision". On the assumption that U.K. accounting policies are being followed provisions for bad debts would be set against the gross value of the loan. In connection with this, in the case of the London Branch of one overseas bank, the Inspector of Taxes responsible for that bank's tax affairs is querying the deductibility of a specific provision claimed by the bank on the basis that the provision was not reflected either in the branch accounts or the accounts of the bank as a whole.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The U.K. Inland Revenue has not stipulated what constitutes acceptable evidence of the objective facts which makes the risk of loan loss probable. The valuation of a debt is a question of fact which in the event of a dispute with the Inspector of Taxes will be decided by the appeals process. The following factors are frequently taken into account:

- (a) the payment history of the borrower, both with regard to interest and principal repayments and in particular whether either are in default.
- (b) the financial condition of the borrower or guarantor.
- (c) the value of any security for the loan.
- (d) for a company in liquidation, the liquidator's estimate of the amount likely to be paid.

Banking businesses are subject to the same requirements as any other traders. However as the amounts involved are frequently larger in the case of banks they are generally subject to greater scrutiny.

UNITED KINGDOM
(continued)

B. Specific Provisions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

The existence of exchange controls over the repatriation of either interest income or principal will not in itself justify a specific provision. However a provision should be allowable to the extent that these controls reduce the market value of the debt or accumulated interest.

Specific relief is available entitling a U.K. taxpayer to elect to have foreign income taxed on a remittance basis in the U.K. where as a result of certain specified circumstances, one of which is the existence of exchange controls, the taxpayer is unable to remit the income to the U.K.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

The Inland Revenue issued a Statement of Practice on January 25, 1983 setting out its views on the deductibility of provisions against country risk debt. A Statement of Practice has no legislative intent but indicates the attitude of the Inland Revenue in areas of technical complexity. The Inland Revenue stated that the taxpayer would have to justify any provision in accordance with the general principles of U.K. tax law and that it was up to each individual bank to decide what provision to make. The Inland Revenue also set out the following points of detail:

- (a) Rescheduling of a debt or interest thereon does not preclude the allowance of a provision.
- (b) A provision against accrued interest will be allowable until such time as it is paid.
- (c) Provisions must be reviewed annually.
- (d) Account should be taken of overseas government restrictions (such as exchange control) on the value of commercial debts.
- (e) The Inland Revenue are prepared to consider special difficulties that arise.

UNITED KINGDOM
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

As set out in the Statement of Practice the rescheduling of a debt will not preclude the allowability of a provision.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

A claim for a tax deduction on a provision should follow the accounting treatment adopted for that provision. A late or early claim is likely to make the provision more difficult to justify.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Where a borrower fails to maintain his scheduled interest payments the usual method of accounting adopted in the U.K. is for the lender to regard the loan as "non-performing" and to take the interest into income on a receipts basis, rather than accruing the full amount of the receivable and then making a specific provision against the outstanding amount. The Inland Revenue accept this practice, provided that it is followed consistently.

UNITED KINGDOM
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are not tax deductible under U.K. taxation law.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

None.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Not applicable.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Not applicable.

5. How is the amount of the provision determined?

Not applicable.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

Not applicable.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

Not applicable.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

Not applicable.

UNITED STATES OF AMERICA

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

A bank may adopt a specific charge-off method, under which it may deduct a loan loss when the loan is charged off.

Most banks, however, provide a loan loss reserve for both financial statement and tax purposes. The calculation of the addition to the loan loss reserve for tax purposes is based on a combination of factors: 1) total loans as of the end of the taxable year, and 2) actual loans charged off during the year. Provisions (i.e., additions to the loan loss reserve, as opposed to actual chargeoffs) made for financial statement purposes with respect to specific loans are not a factor in the tax calculation.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is a ceiling on the total amount of provisions for loan losses which may be deducted in a year.

Banks may determine their addition to the loan loss reserve under either the percentage method (available only for tax years beginning before 1988) or the experience method. Additionally, banks are free to alternate between these two methods from year to year. They may deduct the greater amount and are required by regulations to deduct no less than the lower amount.

If a bank is using the statutorily prescribed percentage method for computing the U.S. tax loan loss reserve, there are three limitations: 1) only certain loans are eligible for the computation; 2) the addition to the prior year reserve cannot exceed the greater of .5% of eligible loans outstanding at the end of the taxable year or an amount sufficient to increase the loan loss reserve to .6% of eligible loans outstanding at the close of the taxable year, and 3) the total reserve may not exceed the greater of a) .5% of eligible loans outstanding at the close of the taxable year (1.2% for tax years beginning after 1975 but before 1982, 1% for 1982), or b) the amount of the reserve at the close of a base year (1982 for tax years beginning in 1983) adjusted downward if eligible loans have declined since the base year.

UNITED STATES OF AMERICA
(continued)

A. General (continued)

If a bank is using the experience method for computing its loan loss reserve, the addition is limited to an amount that would bring the reserve to the greater of 1) a reserve based on a six-year moving average of actual bad debts adjusted for recovery or, 2) the balance of the reserve at the close of a base year (for this method, the last taxable year before the adoption of the experience method), adjusted proportionately downward if total loans have declined since the base year.

As referred to above, for tax years beginning in 1988, all banks on the reserve method must use the experience method.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

A provision which is deducted for tax purposes could be more or less than the amount recorded on the books or the amount required under U.S. generally accepted accounting principles (GAAP).

Banks are not required to conform the loan loss reserve recorded on their books and records to the reserve for tax purposes. Nor are they required to record the excess of the tax reserve over the book reserve in any other account. Under U.S. GAAP, however, a liability account should be established for the deferred taxes relating to this excess.

However, foreign banks doing business in the United States are not required to report under GAAP. Frequently, they conform their books loan loss reserve to the reserve for tax purposes. To the extent that this results in a higher reserve than is necessary under GAAP, one could say that there is a "hidden" reserve.

For many years, U.S. publicly held banks have reported under GAAP (which requires the reporting of future taxes payable) a net deferred tax credit position attributable to this excess tax bad debt reserve, that is, a reserve for future tax liabilities. Since foreign banks doing business in the U.S. do not have to report under GAAP, their records may not reflect a deferred tax liability, and in this respect, they could have an undisclosed liability for taxes.

UNITED STATES OF AMERICA
(continued)

A. General (continued)

As referred to above, for tax years beginning in 1983, the reserve for bad debts computed under the percentage method may not exceed .6% of eligible loans (versus .1% in 1982 and 1.2% from 1976 through 1981). Staked loan loss reserves for U.S. banks generally approach .1% of all loans. Accordingly, we expect some turning around of U.S. banks' net deferred tax credit positions over the next few years and, subject to new legislation a book reserve in excess of the tax reserve.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions for bad debts have historically been deductible at a full normal corporate tax rate, currently 46%. However, the deduction may result in a payment of a minimum tax of 15% on an amount called, for minimum tax purposes, a bad debt tax preference - that is, the excess of the amount claimed in the tax return over what would have been allowed under the six-year moving average method. The preference item is subject to the minimum tax only to the extent to which it reduces taxable income from U.S. sources.

Beginning in 1983, new IRC Section 291 provides that 15% of the bad debt preference described above shall also be disallowed as a U.S. tax bad debt deduction. The amount subject to minimum tax is adjusted accordingly.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

U.S. Tax Authorities can disallow provisions deducted during tax years now closed by the statute of limitations only to the extent the reserve is incorrect and affects open years - for example, during the five-year net operating loss carryforward period available to banks doing business in the U.S. They would require the banks to be restated from the incorrect, albeit closed, years so that proper additions are made during all open and future years. Such restatement would not affect taxable income for the closed years except to the extent a loss is carried forward, utilized, and a portion is attributable to a bad debt deduction.

UNITED STATES OF AMERICA
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

In general, the gross value of a loan remains unchanged with a reserve created separately on the balance and computed as discussed above. When a bank charges off or writes off a loan (either partially or wholly), the gross loan on the balance sheet and the reserve is similarly charged and reduced.

While in most cases, the loss will have been provided for through additions to the loan loss reserve in previous years, where the loan loss reserve for tax purposes is not large enough to cover the loss, the deficienc, in the reserve as well as the reserve itself may be restored to its former level through the computed addition.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

Acceptable evidence of objective facts making the risk of loan loss probable are:

- (a) facts and circumstances, that is - value of collateral securing the debt, financial condition of debtor, nonenforceability of any legal judgement to collect.
- (b) regulatory classifications (a 50% charge is generally made for loans classified doubtful and 100% for loans classified loss). Such regulatory classifications carry a presumption of the correctness of the charge from an IRS point of view.

The evidence requirements may be a bit more objective and presumptive in the banking business than in other businesses.

UNITED STATES OF AMERICA
(continued)

B. Specific Provisions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

While we have found no particular technical support on this point, a bank doing business in the U.S. could probably take a position and claim such a charge to the tax bad debt reserve and readjust the reserve at a later date depending on the eventual outcome of such blocked loan principal and interest.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

U.S. Tax Authorities have not as yet announced a position with respect to country risk loans. Some banks may have claimed a partial charge for certain country risk loans subject to their eventual outcome, IRS examination and review, and adjustment to the reserve.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

Again, it should be stressed that provisions (i.e., additions to the loan loss reserve) are not made with respect to specific loans, except to the extent the loans are actually charged off. Therefore, if a loan is restructured before it has been partially or wholly charged off, the appropriateness of charging it off at that time will depend on the circumstances. If a loan is restructured after it has been partially or wholly charged off, the tax deduction for the addition to the loan loss reserve is not reversed and added back to income. If loan principal and interest is recovered, such recovery is booked to the reserve (and not taxable income), thereby reducing future additions to the reserve.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Yes. However, if the Tax Authorities disallow the addition to the loan loss reserve because it is based on a chargeoff which should have taken place in an earlier year, the bank may file an amended return for the earlier year to claim the deduction, if the statute of limitations is still open. For this purpose only, a special seven-year limitation period applies, in lieu of the usual three-year period.

UNITED STATES OF AMERICA
(continued)

B. Specific Provisions (continued)

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Interest receivable on an eligible loan is itself includible in the eligible loan base upon which the deduction under the percentage method is determined. Similarly, interest receivable on ineligible (as well as eligible) loans is includible in the loan base upon which the deduction under the experience method is determined.

If the regulatory authorities have recommended that a loan be charged off, the interest income accrued to that point should also be charged off, and the interest should not be accrued nor taken into income from that point forward.

If accrued interest charged off is subsequently recovered, the recovery is credited to the tax reserve, not to taxable income.

UNITED STATES OF AMERICA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are made in accordance with specific tax legislation-IRC sections 166 and 385, and supporting regulations, rulings and case law. Such general provisions are affected by specific recommendations from the banking authorities. For example, a loss classification by the banking authorities would be presumptive evidence to charge the bad debt reserve and make a larger addition.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

(a) Loans justifying a general provision under the experience method for computing a reserve include (but are not limited to):

- i. overdrafts in one or more deposit accounts,
- ii. bankers acceptances (to the extent purchased or discounted by the taxpayer)
- iii. loan participations to extent taxpayer bears risk of loss.

Loans for this purpose will not include:

- i. discount or interest receivable reflected in the face amount of an outstanding loan if the discount or interest has not yet been included in gross income,
- ii. commercial paper,
- iii. debt evidenced by a security (bond, debenture, note, or other evidence of indebtedness carrying interest, coupons or in registered form),
- iv. any loan entered into for the primary purpose of enlarging a bad debt deduction,
- v. a loan made in violation of a federal or state statute governing a bank.

UNITED STATES OF AMERICA
(continued)

C. General Provisions (continued)

(b) Eligible loans for this purpose under the percentage method mean loans as defined above but do not include:

- i. a loan to a U.S. bank or the U.S. office of a foreign bank,
- ii. bank funds on deposit in any bank (U.S. or foreign),
- iii. federal funds,
- iv. loans guaranteed or insured, directly or indirectly, by the U.S. government, a possession or instrumentality thereof, or a state or political subdivision thereof, and
- v. a loan secured by a deposit in the lending bank (or in any other U.S. bank or U.S. branch of a foreign bank, to the extent the lending has control over withdrawal of the deposit).

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Again, an addition to the loan loss reserve for tax purposes is not based on specific loans to the extent they have not been specifically charged against the reserve. The loan and eligible loans used in the calculations under the experience and percentage methods are not reduced by the loan loss reserve. Loans which have been charged against the reserve are not included in the calculations.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Under the experience method, yes. Under the percentage method, no, if secured by a deposit defined to mean cash or any instrument that can readily be applied in the event of default. See C.2. b) v. above.

5. How is the amount of the provision determined?

See A.2. above.

UNITED STATES OF AMERICA
(continued)

C. General Provisions (continued)

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

See A.2. above.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

See A.2. above.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No.

WEST GERMANY

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Specific provisions for bad debts must be computed on the basis of an evaluation of the individual loan arrangement or contingent liabilities reflected below the balance on a case-by-case basis. A regulation of the Federal Banking Supervisory Board of September 17, 1974 requires in addition a general bad debt provision on the basis of a certain percentage of all loans and contingent claims outstanding at year end; these rates are minimum rates for the commercial balance sheet. In a regulation of the Federal Government dated July 23, 1974 these rates are at the same time allowed as maximum rate for the tax balance sheet for loans and contingent liabilities for which no specific provision has been set up.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

No, there is no ceiling for justified specific provisions for loan losses or contingent liabilities.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

The evaluation of a risk and consequently the amount of the specific provisions required at a certain balance sheet date is an estimation which is based on facts and circumstances existing at the balance sheet date and becoming known at the date where the balance sheet is finally approved. If the estimation is in accordance with the general accounting principles accepted in Germany and the specific valuation principles for tax purposes the specific provision at a certain balance sheet date can be higher or lower than the provision which is finally needed to cover the loan loss. Such specific provision is still correct and tax deductible at the given balance sheet date.

WEST GERMANY
(continued)

A. General (continued)

Paragraph 6, subparagraph 2 No. 2 Income Tax Act provides that assets like a loan may be valued at a given balance sheet date with their lower going concern value ("Teilwert"). The going concern value of an asset is defined as the amount which upon acquisition of the business as a whole would be suballocated from the total purchase price to the asset concerned.

For commercial balance sheet purposes the bank management may take a more conservative approach and set up a higher specific reserve than allowed for tax purposes. In addition German banks are allowed to arbitrarily state receivables and securities below market value according to Paragraph 26 a) Banking Act, thus creating hidden reserves in the commercial balance sheet which can be dissolved at any future time; these arbitrary reserves are not allowed for tax purposes.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Additions to the specific provisions for loan losses or to the general bad debt provision are regular business expenses. They reduce the basis for trade tax on income (tax rate between 15% and 20%) and corporation tax (tax rate between 36% and 56%).

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

Taxable income is established on the basis of annual tax balance sheets and profit and loss statements. Consequently, Tax Authorities may disallow additions to specific or general bad provisions which were established in years which are subject to the statute of limitation in the first subsequent year which is not subject to statute of limitation.

WEST GERMANY
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

Specific (and general) provisions for loan losses are deducted from the loans on the asset side of the balance sheet. Specific (and general) provisions for contingent liabilities are posted on the liability side of the balance sheet. If the specific provision is increased in a later year the additional amount is deducted from the loan on the asset side of the balance sheet or posted on the liability side of the balance sheet in the case of contingent liabilities. Specific provisions may be maintained until repayment of the loan even if in later years the creation of a specific provision would not be justified on the basis of the then existing facts and circumstances. A loan is finally written off if any reasonable effort for collection has been made without success.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

The valuation principles for tax purposes are the same in the case of banks and other business entities. The reasons which justify specific bad debt provisions are, therefore, in principle the same which under generally accepted accounting principles in Germany would require that an orderly and cautious business manager would set up a reserve.

Insolvency, overindebtedness and the necessity to start legal proceedings justify specific reserves for bad debts. Deferred payment and illiquidity may justify specific reserves for bad debts. In cases where repayment of the principal amount of a loan is deferred by agreement, in general, the Tax Authorities take the position that no specific provision for bad debts is justified.

WEST GERMANY
(continued)

B. Special Provisions (continued)

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange control restrictions regarding repayment of a loan or payment of interest in general do not justify a specific provision according to the practice of the German Tax Authorities. However, in specific situations it is conceded that exchange control restrictions justify specific provisions for bad debts; this was done by a letter of the Federal Minister of Finance of April 23, 1979 with regard to Turkey.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

Until recently German Tax Authorities have taken a defensive position with regard to considering country risks. However, in a preliminary decision of August 23, 1982, the Hessian Fiscal Court has approved a bad debt reserve of 50% on loans to a Polish bank as of December 31, 1982. In the meantime, on March 7, 1983 the Federal Ministry of Finance has issued a letter which, in general terms, concedes that country risks, especially transfer risks may be considered when establishing special bad debt provisions.

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A specific provision for bad debts which has been justified at a certain balance sheet date must not, but may be released at a later balance sheet date if the circumstances regarding the evaluation of the loan have changed.

WEST GERMANY
(continued)

B. Specific Provisions (continued)

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

A specific provision for bad debts has to be set up at the balance sheet date when it is necessary, applying generally accepted accounting principles. If a bank would not adhere to that principle it would still have the same obligation at the next balance sheet date. A tax deduction could only be disallowed if the original year in which the specific bad debt provision was required falls under statute of limitation and it can be proven that the taxpayer has not set up the provision in that year in order to defer the loss taxwise. Since banks have to set up their commercial balance sheet with the care of a cautious and orderly business manager and the commercial balance sheet is the basis for the tax balance sheet these situations would be the rare exceptions.

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks have to value the claims for interest payments in the same manner as loans. Where a debtor is in default of payment of principle and interest the bank may instead of capitalizing an interest receivable and setting up a specific bad debt provision with regard to the claim for interest payment just not capitalize this claim.

WEST GERMANY
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

As mentioned under A.1. under a regulation of July 23, 1974 issued by the Federal Government banks may set up general bad debt provisions for loans and contingent liabilities for which no specific provisions have been made. The regulation is based on Article 108 of the German Constitution and is binding for the tax offices.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

The percentages for general bad debt provisions for loans outstanding and contingent claims are as follows:

	Banks in the legal form of sole proprietorship general partnership and limited partnership %	Banks in other legal forms %
Bills		
Own drawings	1.8	1.05
Other	0.9	0.525
Loans to customers with agreed maturities or at agreed notice of less than four years	1.8	1.05
Loans to customers with agreed maturities or at agreed notice of four years and over		
Granted against charges on Real estate	0.1	0.1
Other	0.5	0.5
Contingent claims in re- spect of bills in cir- culation drawn by the bank, discounted and credited to borrowers	1.5	1.05

WEST GERMANY
(continued)

C. General Provisions (continued)

Banks in the legal form of sole proprietorship general partnership and limited partnership %	Banks in other legal forms %
--	------------------------------------

Contingent claims in re-
spect of guarantees,
guaranteed bills and
dispute and guarantee
agreements as well as
endorsements on re-
discounted bills

0.9

0.525

No general bad debt provisions are allowed for the follow-
ing loans and contingent claims:

- (a) amounts due from the German Federal government, German states (Länder), German municipalities or other German public corporations and institutions for which German governmental bodies (Federal Government, state or municipality) have guaranteed;
- (b) amounts due from foreign states, foreign govern-
mental bodies or other foreign public corporations
and institutions;
- (c) amounts due from banks;
- (d) amounts guaranteed by one of the entities mentioned
in Nos. 1 to 3;
- (e) amounts for which the bank has taken out credit
insurance;
- (f) amounts for which a specific bad debt provision has
been established.

3. Are credits which have been provisioned on a specific basis
included in the basis of calculation for the general provision?

No.

4. Are credits which have been secured included in the basis of
calculation for the general provision?

Yes, except where the risk is guaranteed by an entity
mentioned under C.2.1. through 3.

WEST GERMANY
(continued)

C. General Provisions (continued)

5. How is the amount of the provision determined?

See C.2. above.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

See C.2. above.

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

No.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

No, as mentioned under A.1. above the general bad debt provisions for tax purposes are required as minimum bad debt provisions for commercial balance sheet purposes.

VENEZUELA

A. General

1. Are tax deductible provisions for loan losses computed on a loan-by-loan basis only (specific provisions), or are they computed on a global basis only (general provision), or are both systems combined?

Provisions for bad debts must be computed on a loan-by-loan basis. In accordance with the Venezuelan Income Tax Law, provisions for bad debts are not deductible and losses are to be deducted only in the fiscal year when the loan is effectively written off.

2. Is there a ceiling on the total amount of provisions for loan losses which may be deducted for a year (e.g., as a percentage of total loans, or as an average of past years' losses)?

There is no ceiling on the total amount of provisions (i.e., write-offs) for loan losses which may be deducted for a year. The banks can provide whatever they wish; however, such general provision is not tax deductible.

3. Is it the case that a provision which is deducted for tax purposes could be more or less than the amount which would actually be needed? Could the excess fiscal provision lead to a hidden reserve? Or could conservative accounting principles lead to a book reserve amount exceeding the tax deductible provision?

See above - no general provision can be deducted for tax purposes, even if that is more or less the amount which would actually be needed. Thus, it is not possible that an excess fiscal provision can lead to a hidden reserve. Conservative accounting principles could lead to a book reserve amount exceeding the tax deductible amount.

4. Are tax deductible provisions always deductible from the basis of assessment of corporate tax at full rate? If not, indicate cases where this may be different.

Tax deductible provisions (in Venezuela, only charge-offs) are always deductible from the basis of assessment of corporate tax at full rate. Losses from loans are tax deductible when they comply with the following conditions:

- (a) That the debts are due to operations proper to the business;

VENEZUELA
(continued)

A. General (continued)

(b) That the amount of the same has been taken into consideration for computing the gross income declared (this restriction does not apply in the cases of losses of capital given as loan by credit institutions or of losses due to loans granted by the companies to their workers); and

(c) That those have been written off during the taxable year due to the bankruptcy of the debtor and of his guarantors, or because the amount involved does not justify collection costs.

5. Can the Tax Authorities disallow provisions deducted during years which are barred to auditing by the statute of limitation? If yes, under what circumstances, and in the accounts for which year are the provisions reversed?

The Tax Authorities cannot disallow write-offs deducted during years which are barred to auditing by the statute of limitation. During any open tax year, the authorities may disallow bad debts incorrectly deducted by the taxpayer; such a disallowance would not cause any penalty.

VENEZUELA
(continued)

B. Specific Provisions

1. Does the anticipated loss of a loan require a direct write down, or does the gross value of a loan which is considered doubtful remain unchanged, with a reserve being created separately on the balance sheet? In the latter case, when and how is the uncollectable loan eventually written off?

The anticipated loss of a loan does not require a direct write-down; the gross value of a loan which is considered doubtful remains unchanged, with a reserve being created separately on the balance sheet. The uncollectable loan is eventually written off when the bank accepts that there is no hope - the borrower is declared in bankruptcy or his guarantors do not pay the debt.

2. For the Tax Authorities, what constitutes acceptable evidence of objective facts which make the risk of loan loss probable? Are evidence requirements looser in the banking business than in other sectors?

For the Tax Authorities, acceptable evidence of objective facts which make the risk of a loan loss probable are as set forth above in A.4. The evidence requirements are looser in the banking business than in other sectors.

3. Do Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor justify a tax deductible provision?

Exchange Control restrictions on the repayment of a loan or on the payment of interest by the debtor do not justify a tax deductible provision. A loss on a loan to a borrower outside Venezuela is not deductible in any case due to the territoriality concept of the Venezuelan Income Tax Law. A foreign non-domicile bank cannot deduct any expenses in Venezuela, not even salaries, bad debts, or interest paid are not deductible.

4. Have the Tax Authorities taken a position as to the relevance of country risk, to justify a specific provision? What is the banks' position in this area?

The Tax Authorities do not take a position as to the relevance of country risk to justify a specific provision. Income earned abroad is not taxable and off-shore losses are not deductible.

VENEZUELA
(continued)

B. Specific Provisions (continued)

5. Can a provision made with respect to a loan be maintained if the loan is restructured?

A provision made with respect to a loan is not deductible to begin with, so it cannot be maintained (tax-wise) if the loan is restructured - it has no tax significance.

6. Is timing a relevant factor vis-a-vis the tax deductibility of a provision for loan losses? (In other words, could a provision be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss probable?)

Timing could be a relevant factor vis-a-vis the tax deductibility of a provision for loan losses. A provision could be disallowed if not deducted during the fiscal year during which the event occurred which makes the loss absolutely certain ("probable" is not quite enough).

7. Do banks have to take into income the interest accrued on provisioned loans. If yes, may they provision it immediately?

Banks do not have to take into income the interest accrued on provisioned loans. For Venezuelan tax purposes, the interest on discount operations, whose product is recoverable in various annual installments, the income is considered available proportionally to the amount that corresponds to each fiscal year. Any "accrued" interest is not taxable for Venezuelan income tax purposes.

VENEZUELA
(continued)

C. General Provisions

1. Are general provisions made in accordance with:
- specific tax legislation?
 - individual agreement with the Tax Authorities?
 - specific recommendations from the Banking Authorities?
 - individual agreement with the Banking Authorities?
 - accepted common practice?
 - other?

General provisions are not tax deductible, but can be made in accordance with the Venezuelan Income Tax Law and its Regulations as non-recognized and non-deductible items.

2. List kinds of credits which may justify a general provision, and give fiscal definition of these credits.

Any credit, except those with mortgage security, may justify a general (but non-deductible) provision. However, a credit to the public sector (government entities) can never be considered insolvent (or a bad debt) for Venezuelan tax purposes.

3. Are credits which have been provisioned on a specific basis included in the basis of calculation for the general provision?

Credits which have been provisioned on a specific basis can be included in the basis of calculation for the general (but non-deductible) provision.

4. Are credits which have been secured included in the basis of calculation for the general provision?

Credits which have been secured are normally included in the basis of calculation for the general (but non-deductible) provision.

5. How is the amount of the provision determined?

The amount of the non-deductible provision is usually determined based on the risk of the unsecured credits.

6. If it is by application of rates fixed by law or regulations, what are these rates? If several rates are used for different kinds of credits, list the credits.

There are no rates fixed by law or regulations.

VENEZUELA
(continued)

C. General Provisions (continued)

7. Are there any limits applicable to the yearly increase of the general reserve? How are these limits established?

There are no limits applicable to the yearly increase of the (non-deductible) general reserve.

8. May general provisions, although deducted for tax purposes, be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes?

General provisions, which cannot be deducted for tax purposes, cannot be considered as a segregation of retained earnings, and thus be included in the bank's equity for accounting purposes.

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Report on the Bad Debt Deductions of Commercial
Banks under the Federal Income Tax Law

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Bank Administration Institute
New York Clearing House
Association
April 22, 1985

(i)

SUMMARY

This report analyzes the portion of the Treasury Department's tax reform proposal (which was sent to the President in November 1984) pertaining to the bad debt deductions of commercial banks.

TREASURY'S PROPOSAL AND THE GAAP PROPOSAL

In its report, the Treasury Department recommended eliminating the reserve method of treating bad debts and permitting a tax deduction only for those debts actually written-off in the current year. Its basis for this proposal was that the reserve method of treating bad debts allegedly improperly accelerates bad debt deductions without discounting the deductions to their present value.

The conclusion reached in this report is that the reserve method for treating bad debts should be retained. In addition, we recommend that the reserve be based on generally accepted accounting principles ("GAAP") and regulatory standards (which are synonymous with GAAP in this area).

COMPARISON OF THE TWO PROPOSALS

In the remainder of this summary section, we compare Treasury's proposal to move to a specific charge-off method of accounting for bad debts with our recommendation that a bad debt reserve based on GAAP and regulatory standards be maintained. This comparison focuses on three major issues -- (i) fairness, (ii) ease of administration, and (iii) compatibility with bank regulatory goals.

A. Fairness

1. Summary. For purposes of making a comparison on this issue, we start with Treasury's own definition of an "ideal" tax system as being one "as neutral as possible towards private decisions." In such a system, scarce capital resources are allocated efficiently between different competitors in the capital markets because each competitor is paying tax at the same rate on their economic income. Based on this

(ii)

framework of reference, we find that the GAAP proposal would more nearly result in a tax on economic income than the Treasury proposal. Accordingly, using this standard of reference, it is the fairer system.

2. Discussion

a. Treasury's proposal. Under the tax law, a debt may be written-off when it becomes wholly or partially worthless. Worthlessness is defined as being destitute of value, valueless or useless. Treasury's proposal would defer any deduction for bad debts until this condition of "valueless" was determined to exist.

We believe, however, that the economic loss attributable to credit risks occurs much earlier than the point when a loan can be formally written-off for tax purposes. The write-off of a loan is the last step taken in what is normally a drawn-out process. The process begins when a loan becomes troubled, continues through a work-out period and culminates when the loan is collected or written-off in full or in part. A proper bad debt reserve represents the economic losses already inherent in a loan portfolio before the loans involved are formally written-off. There is no need to discount any deduction back to its present value.

Accordingly, the major infirmity in the Treasury proposal is that it forces the postponement of loan loss expense until a period after this expense economically has been incurred. In the intervening periods, a bank will recognize interest income, which includes an element to compensate it for the risk that a loan may not be repaid. The bank's bad debt expense should be matched against this interest income, but under the Treasury proposal it will not be. Consequently, the Treasury proposal will not tax a bank on its true economic income.

Treasury's proposal to disallow bad debt reserves is comparable to disallowing depreciation deductions for fixed assets. By analogy, if a manufacturer acquired a machine, Treasury's proposal would not allow any depreciation deductions until the machine was scrapped. Disallowing a depreciation reserve would distort a manufacturer's taxable income. For the same reason, disallowing a bad debt reserve would distort a bank's taxable income.

Indeed, while proposing to eliminate bad debt reserves, the Treasury Report will permit taxpayers to index inventories and capital assets to bring their taxable incomes more closely in line with their economic incomes. These adjustments, while theoretically available to banks, will in most instances not be important to them. Similarly, while all taxpayers are to be deprived of the reserve method of calculating bad debt deductions, this deduction is not nearly as significant to taxpayers that are not financial institutions. Thus, we believe that the Treasury proposal discriminates against banks when it comes to establishing a neutral tax system.

b. GAAP proposal. Although no system is perfect, a bank's pretax income as determined under GAAP is intended to represent its economic income. As part of reaching this goal, GAAP requires a bank to use a loan loss reserve. For the reasons previously given, we believe that the use of a loan loss reserve is consistent with a tax on economic income.

B. Ease of Administration

1. Summary. The Treasury proposal to use a specific charge-off method may lead to protracted disputes between the IRS and

taxpayers about the timing of bad debt deductions. Reliance on GAAP would avoid any such controversies. Further, we believe that the scrutiny of a bank's loan loss reserve by bank regulators, auditors and other third parties places banks in a special category where reliance on figures determined in accordance with GAAP is warranted.

2. Discussion

a. Treasury proposal. The reserve method of accounting for bad debts was first authorized by Congress in 1921 to reduce the volume of disputes concerning the proper time at which a debt should be written-off. Was a debt truly bad? When did it go bad? Was it this year or a prior year? Although these issues cannot be avoided altogether, the reserve method of accounting tends to reduce the disputes on these issues to a manageable level.

b. GAAP proposal. The GAAP proposal will provide an easily administrable standard. We believe that reliance on GAAP is fully warranted for the reasons discussed below.

First, the IRS has recognized that in appropriate circumstances, a tax loan loss reserve should be determined under GAAP. See, G.E. Westchester Development Co., 63 T.C. 198, 203-206 (1974), acq., 1975-2 C.B.2; Rev. Rul. 76-362, 1976-2 C.B. 45. Thus, legislative adoption of GAAP for purposes of determining a bank's loan loss reserve would not be an abrupt departure from the existing law. Second, the reasonableness of a bank's bad debt reserves are subject to intense scrutiny by a number of disinterested parties, including bank regulators, the bank's outside auditors, creditors and bank analysts. Hence, the need for yet another independent audit by the IRS is not present.

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C. Compatibility with bank regulatory goals

1. Summary. Current regulatory practices require banks to maintain bad debt reserves in an amount equal to the amount determined under GAAP. This regulatory policy is designed to protect the safety and soundness of the banking system. Treasury's specific charge-off proposal may thwart these regulatory goals. The GAAP proposal should act in consonance with them. Further, the adoption of a regulatory standard in the tax law in this area is in keeping with certain analogous precedents.

2. Discussion

a. Treasury proposal. Although obviously not intended to lead to an unfortunate result, the Treasury proposal to require banks to use the specific charge-off method of accounting for loan losses may work against sound regulatory objectives. In particular, where bank management is advised, on the one hand, to maintain adequate bad debt reserves but are told, on the other, that it will not be allowed a tax deduction for additions to these reserves, management may be discouraged from satisfying the former objective.

b. GAAP proposal. The GAAP and regulatory standards for bad debt reserves are the same. Thus, the GAAP proposal would be consistent with regulatory guidelines and would encourage management to keep adequate reserves.

Furthermore, although the IRS generally has not treated regulatory accounting practices as binding for tax purposes (Rev. Rul. 68-220, 1968-1 C.B. 194), there is authority that regulatory policies are to be

(vi)

accorded deference (Comm'r. v. Idaho Power Co., 418 U.S. 1, 15 (1974)). This has been particularly the case where the timing of loan charge-offs or the nonaccrual of interest by a financial institution has been in question.

For example, Reg. §1.166-2(d)(1) provides that loans written-off in response to the orders of regulatory authorities or in accordance with established regulatory policies (the charge-off of which is later confirmed in writing by the regulators) will be conclusively presumed to be worthless. Further, in Rev. Rul. 81-18, 1981-1 C.B. 295, the IRS followed the rules of the Federal Home Loan Bank Board as to the write-off of accrued interest on a loan where the interest was due and unpaid for a period of more than 90 days.

The question of when a loan should be charged-off or the point when no additional interest on a loan should be accrued both involve the same type of judgment as is involved in determining the adequacy of a loan loss reserve. The tax law permits or invites the use of regulatory guidelines in the first two cases. There is no good reason why regulatory provisions should not be accorded deference in the case of bad debt reserves.

CONCLUSION

We recommend that banks be allowed to maintain bad debt reserves for tax purposes and that any such reserve be calculated in accordance with GAAP. We make this recommendation because we believe the GAAP proposal (i) is in accord with Treasury's announced goal of an economically neutral tax system, (ii) can be easily administered, and (iii) will be consonant with regulatory goals for a safe and sound banking system.

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Report on the Bad Debt Deductions
of Commercial Banks under the
Federal Income Tax Law

This report was prepared jointly by the Bank Administration Institute, the New York Clearing House Association and Peat, Marwick, Mitchell & Co. to analyze the portion of the Treasury Department's tax reform proposals issued in November 1984 pertaining to the bad debt deductions of commercial banks. In addition, the report recommends appropriate standards to be used in allowing such deductions in the future.

I. TREASURY DEPARTMENT'S PROPOSAL

A. The Proposal. In its November 1984 report to the President, the Treasury Department proposed to repeal the current provisions in the Internal Revenue Code ("IRC") providing for the additions to bad debt reserves by commercial banks and thrift institutions. In lieu of the current provisions, the Treasury Department proposed that "bad debt losses be deducted only as they occur." The Treasury Department Report to the President, "Tax Reform for Fairness, Simplicity, and Economic Growth," Vol. 2 at 247 (November 1984) (hereinafter, the "Treasury Report"). The portion of the Treasury Report dealing with bad debts is contained in Exhibit A appended to this report. This change to the specific charge-off method of deducting bad debts is to be effective for all taxable years beginning on or after January 1, 1986. Institutions would be required to amortize existing reserves into income over a ten-year period beginning with the first affected year. Id. at 247.

The Treasury Department also proposes to repeal the reserve method of treating bad debts for all other taxpayers as well as depository institutions. This general repeal would be effective on the same date. Treasury Report, Vol. 2 at 218-222.

B. Rationale Behind the Treasury Proposal. In justification for its general proposal to repeal the reserve method of treating bad debts, the Treasury Report states that the reserve method ends up "distorting the timing of taxable income" because it "represents a deduction for future loan losses ... without any discount for the present value of such losses." It also was said to discriminate "in favor of firms with growing accounts receivable or worsening loss experience." Treasury Report, Vol. 2 at 218-219.

As for the repeal of the special provisions for depository institutions, the Treasury Report found that the "reserves for bad debts are overstated for depository institutions compared to bad debts for other businesses." For example, purportedly "58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans" in 1983 (0.6 percent being a statutorily authorized measure of a loan loss reserve for commercial banks provided currently in the IRC). As a result of the foregoing, the Treasury Report concluded that the "lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates." Treasury Report, Vol. 2 at 247-248.

II. RECOMMENDED BAD DEBT PROVISION

For the reasons discussed in detail in the balance of this report, we recommend that (i) the reserve method of treating bad debts be retained for commercial banks, and (ii) any bad debt allowance be calculated in accordance with generally accepted accounting principles ("GAAP").

Our reasons for making this proposal may be summarized as follows. First, we feel that the reserve method of accounting for bad debts results in a proper matching of income and expenses and does not (as was asserted in the Treasury Report) result in a distortion of income or some

kind of artificial support of low interest rates. Second, we believe that our suggested reserve method is not an abrupt departure from existing law. Third, we also believe that the recommended method will be consistent with bank regulatory policies and not antagonistic to it as Treasury's suggested method may be. Fourth, we submit that the suggested reserve method is a better measure of economic reality than the specific charge-off method contained in the Treasury Report and, thus, furthers Treasury's goal of having an economically neutral tax system. Finally, we feel that our recommendation is sufficiently objective for tax purposes.

III. BACKGROUND

A. History of Current Bad Debt Tax Methods for Banks. The reserve method of accounting for bad debts was first made part of the IRC in 1921 with the passage of the Revenue Act of that year. Revenue Act of 1921, §214(a)(7). The evident reason for the new provision was that the old law only permitted a bad debt deduction in full or not at all, which had led to disputes with the revenue service over the timing of deductions. The new section permitted use of a reserve method and partial write-offs to alleviate these problems. See J.S. Seidman, Legislative History of the Income Tax Laws: 1938 - 1861 (1939) at #31-833.

In 1947 the Internal Revenue issued a mimeograph authorizing banks to compute their bad debt deduction by using an experience factor based on the average ratio of bad debt losses to outstanding loans over the preceding 20-year period (the so-called "20-year moving average" method).

Mimeograph 6209, 1947-2 C.B.26. This was the first pronouncement by the Revenue Service as to how a bank was to compute its bad debt deduction using a reserve method. In 1954 the earlier pronouncement was modified so that a bank could use an experience factor based on any consecutive

20-year period, provided the bank's overall reserve did not exceed three times the product of the experience factor and the bank's current outstanding loans.

In 1963, after reviewing its experience with the 20-year average methods of computing a bank's bad debt deduction, the Service concluded that the methods "resulted in large variances in reserves among banks and in reserve ceilings not related to the probability of bad debts on outstanding loans." Rev. Rul. 63-92, 1963-1 C.B. 112. This conclusion evidently was based on the fact that the bad debt write-offs taken in the depression no longer seemed pertinent in the post-war period and the fact that never banks could not refer back to pre-war periods to substantiate a high experience factor based on their own experience. In substitution for the 20-year moving average methods, the IRS authorized banks to calculate a reserve based on 2.4 percent of loans outstanding at the close of the taxable year. However, the ruling also permitted use of a "probable experience method" under the provisions of section 166(c) based on "the total amount of the existing reserve and current business conditions, the nature of the bank's past experience, and other [relevant] factors ...". The addition to a reserve on the experience method was to be "regarded as reasonable" if it did not exceed a reserve addition based on a six-year moving average. See also Rev. Rul. 68-630, 1968-2 C.B. 84 (the Service defined those loans "eligible" for inclusion in the percentage calculation).

In the Tax Reform Act of 1969 (P.L. 91-172), Congress moved to change the effect of Rev. Rul. 63-92. Finding that the 2.4 percent percentage method overstated the reserves of many banks, it enacted section 585 of the IRC with the intent that after a transitional period all banks would be put on a six-year moving average experience method. H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 120-122. Congress wrote extensive transition rules into the statute with the result that the applicable

percentage was to be reduced beginning after 1981 and phased out entirely for taxable years beginning in 1986. Until then, banks will be permitted to use a six-year moving average or a percentage method of computing their bad debt deduction. To protect banks against the possibility of unusually large bad debt write-offs in the absence of generous bad debt reserves, Congress gave banks the right to carry back net operating losses for 10 years instead of the three years then provided. *Id.* at 275; IRC §172(b)(1)(F). The Tax Reform Act of 1969 also made banks subject to a minimum tax by treating as a tax preference item, among other things, the excess of a bank's loan loss addition claimed as a deduction over the bad debt deduction allowable based on an actual experience basis. IRC §57(a)(7).

In the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), Congress further reduced a bank's bad debt deduction under a new scale-back provision. That provision reduced the bad debt deduction by 15 percent of an amount equal to the excess of a bank's bad debt deduction actually claimed over the deduction allowable on the basis of actual experience. IRC §291(a)(3). To avoid a scale-back in a bank's bad debt deduction while a bank at the same time paid a minimum tax on the full bad debt preference item, Congress made a corresponding adjustment to the calculation of the amount of the bad debt deduction treated as a preference item for minimum tax purposes. IRC §57(b)(1)(A). The Tax Reform Act of 1984 (P.L. 98-369) increased the scale-back to 20 percent and further adjusted the amount treated as a bad debt preference item (at present, 59 5/6 percent of the bad debt preference item is actually to be taken into account in computing a bank's minimum tax liability).

At present, then, banks may for tax years beginning before 1988 compute an addition to their reserve for loan losses using either the percentage method (with a 0.6 percent rate) or a six-year moving average experience

method. For taxable years beginning in 1988 and thereafter, only the experience method may be used. Moreover, if a bank uses the percentage method, it may be liable for a minimum tax based on a bad debt preference item.

8. Bad Debt Reserve Deductions Allowed Other Taxpayers. Section 166(c) of the IRC allows taxpayers (in the discretion of the Commissioner) to claim "a deduction for a reasonable addition to a reserve for bad debts." The regulations issued under section 166(c) amplify this provision somewhat by providing:

What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business property. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. Reg. §1.166-4(b)(1).

The history of the reserve method under section 166(c) has largely been the history of the decision in Black Motor Co., 41 B.T.A. 300 (1940), acq., 1940-1 C.B. 1, aff'd on other grounds, 125 F. 2d 977 (6th Cir. 1942). In that case, the Board of Tax Appeals approved of the Revenue Service's use of a six-year moving average method to adjust the taxpayer's deduction for additions to its bad debt reserve. Since that time the so-called Black Motor formula has been widely adopted.

Even though widely employed, the relevant precedents are clear that the Black Motor formula is only to be used where the facts and circumstances are such that its application results in a reasonable addition to a bad

debt deduction. Where the taxpayer can demonstrate that a greater amount than that determined under the Black Motor formula should be allowed as deduction, the Commissioner would abuse its discretion in not allowing the greater deduction. In Westchester Development Co., 63 T.C. 198 (1974), acq., 1975-2 C.B. 2, the Service's use of a reserve formula based on the first year's business experience of a company to adjust the company's bad debt deduction was held to be in error. Instead, the taxpayer was allowed to use its reasoned judgment of what the reserve should be based on "an addition which petitioner was advised to make to its bad debt reserve by a nationally known firm of certified public accountants whom petitioner had engaged to conduct an audit..." Id. at 205-206. The CPA's advice, in turn, was based on an extensive review made by the accounting firm in determining the appropriate reserve figure for GAAP purposes. See also Rev. Rul. 76-362, 1976-2 C.B. 43.

Moreover, in many cases, the "math" of the Black Motor computation does not work to give a satisfactory bad debt reserve figure even assuming the historical experience upon which the Black Motor computation is based is currently relevant. This point is examined further in Section V.A.3 below.

In sum, the present law as applied to taxpayers other than depository institutions permits use of a bad debt reserve method, pursuant to which deductions are frequently determined by reference to the Black Motor formula. However, in appropriate circumstances, an amount greater than an amount determined using Black Motor may be deducted, and these circumstances include, among other things, a determination that another amount is required for GAAP purposes.

C. Recent Congressional Review of Bank Bad Debt Reserve Deductions. In the first part of 1983, the Senate Finance Committee undertook to review the taxation of banks, savings and loan associations

and credit unions. In connection with this review, the staff of the Joint Committee on Taxation undertook a study of the taxation of these institutions. This study was published as a Joint Committee print under the title "Taxation of Banks and Thrift Institutions" (March 9, 1983) (hereinafter, the "Joint Committee Study"). The pertinent findings of this study relating to the bad debt reserve methods used by commercial banks are discussed below. (A copy of the pertinent portions of the Joint Committee Study is annexed hereto as Exhibit B.)

First, relying on several studies conducted by other organizations, the Joint Committee Study reviewed the deferred taxes created by bank loan loss reserves. A deferred tax is created for GAAP purposes when the tax liability calculated on financial statement taxable income is either higher or lower than the current tax liability of a company. The conclusion of the Joint Committee Study regarding the deferred taxes created by bank loan loss reserves was:

Typically, in years prior to 1981 the additions to the loan loss reserves for book purposes were lower than those allowed for tax purposes. In those years banks had the benefit of the tax deferral. More recently, during a period of economic uncertainty, the additions to the loan loss reserves for book purposes, determined under management's best judgment of expected loan recovery rates have often been greater than the amounts allowed for tax purposes. Joint Committee Study at 21.

In other words, the bad debt deductions claimed for financial statement purposes have been on the average both higher and lower than the bad debt deductions claimed by banks on their tax returns. Further, the financial statement bad debt expense appears to have been lower in periods of relative economic tranquility and higher in the 1982 and 1983 period of

economic distress. Viewed in this light, the financial statement figures would seem to be a judicious blending of the judgment of bank management, their regulators and outside auditors.

Second, after reviewing the various theoretical approaches to the computation of a proper bad debt reserve, the study concluded that the "issue of how best to determine an experience based bad debt reserve is a complicated one" and that "Congress may want to study possible technical modifications of the present experience method ..." Joint Committee Study at 32. The study did not suggest that the entire reserve system be revoked as the Treasury Report now recommends.

Finally, although the study discusses the possibility that the bad debt deductions of thrift institutions constitute a so-called "tax expenditure" (i.e., a benefit bestowed by the government in the form of a "tax deduction" not supported by the underlying economic circumstances), the study does not speak of bank bad debt reserves in the same vein. Consequently, we believe that the Joint Committee Staff did not view bank bad debt deductions as tax expenditures. Joint Committee Study at 32-33.

IV. GAAP AND REGULATORY ACCOUNTING

A. GAAP Accounting for Bad Debts. The principal source of GAAP as applied to banks is found in the industry guide issued by the American Institute of Certified Public Accountants entitled "Audits of Banks" (2nd ed.) (hereinafter, the "Bank Audit Guide").

1. Application of GAAP to banks and bank holding companies. GAAP applies to all commercial banks and bank holding companies which issue securities to the public and file financial statements with the Securities and Exchange Commission (the "SEC") or with the various bank regulatory agencies. Rule 4-01 of Regulation S-X of the SEC states that

"financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosure, unless the Commission has otherwise provided." The Division of Corporate Finance of the SEC reviews the registration statements and annual financial statements filed with it by the banks that are subject to its jurisdiction. The division is responsible for ensuring that the information presented in these documents is complete and not misleading. As will be discussed in Section IV, B, GAAP also is applied to banks not subject to the supervision of the SEC by virtue of the adoption of these accounting principles by bank regulators.

2. Operation of the allowance for loan losses under GAAP. The Bank Audit Guide provides that the "allowance for loan losses is the estimated amount of losses in a bank's portfolio ...". The amount is "reasonable when the allowance ..., including the current provision, is considered by management to be adequate to cover [these] estimated losses..." Further, the "propriety of the accounting treatment should be judged according to the adequacy of the allowance determined on a consistent basis, not the provision charged to operating expenses." Bank Audit Guide at 61. However, in setting the allowance for loan losses, bank management is not trying to predict the losses that may occur at some remote time in the future; rather, only current conditions that can reasonably affect the collectibility of current loans should be taken into account.

Charges to income create the loan loss reserve. Thereafter, loan write-offs are deducted from the reserve, and recoveries are added to it. Loans are to be written-off when they are determined to be uncollectible. A recovery is taken when the bank receives cash or a cash equivalent attributable to a loan previously written-off. The bad debt

expense is then equal to the difference between the beginning reserve adjusted for charge-offs and recoveries and the amount of the reserve that is determined to be required at the end of the year.

There is no authoritative literature that defines precisely what constitutes an adequate allowance for loan losses. This is because banks operate in different financial environments and have different loan portfolios. Thus, careful consideration and professional judgment is necessary to evaluate the adequacy of the allowance for loan losses and the activity within the account at individual banks.

3. Management responsibility to maintain an adequate allowance for loan loss reserves. The maintenance of an adequate allowance for loan loss is the responsibility of the bank's management. However, the adequacy of the allowance for loan loss is subject to significant independent review by a bank's outside auditor and the regulatory agency (or agencies) supervising it.

In calculating the bank's reserve, bank personnel will typically attempt to segregate their loans into different categories. Troubled loans that are significant in principal amount will normally each be reviewed and a decision made as to what (if any) percentage of the loan should be reserved against. The reserve percentage will be based on the amount bank management reasonably believes it can collect from the borrower or realize from the collateral securing the loan given the current financial condition of the borrower and the present worth of the collateral. Reserves will also typically be placed against other portfolios of loans having common characteristics without individual review of all of the loans in the portfolios. For example, energy loans made to a certain type of borrower and secured by the same type of property might be classified together, and certain of the loans randomly selected to be reviewed. Based on the review of these loans, a reserve for the full

portfolio in question (typically at a percentage of the total principal amounts) will be created. Reserves for other portfolios will be created in a similar fashion or based on other factors, such as the bank's historical experience with the credit risks involved. Some loan portfolios will be viewed as needing little, if any, reserves. Finally, the reserves established in the above fashion will be combined together to determine an overall reserve. Management will then make a general review of the entire reserve to ensure that it is adequate as a whole.

Each bank should have a system in place to ensure that a proper analysis of all relevant factors pertinent to the evaluation of the allowance for loan loss is performed by management. This evaluation should be documented to facilitate its review by senior management, bank examiners and the bank's outside auditors. The allowance for loan losses should be reviewed periodically by management to ensure that it is being maintained at an adequate level.

4. Procedures performed by independent auditors in evaluating the allowance for loan losses. As part of the independent auditor's audit of the financial statements of a bank, the independent auditor evaluates the reasonableness of the allowance for loan losses under the facts and circumstances pertinent to that bank. While management is responsible for calculating the amount of the allowance for loan losses, the auditor is responsible for obtaining "reasonable assurance" that the proper amount has been recorded. Moreover, "[s]ince loans are generally a bank's largest single class of assets and generally present the highest potential for loss," the CPA should expect to spend considerable time in the audit process focusing on this area and to encounter substantial interest by other parties (high bank management, regulators, etc.) with respect to it. Bank Audit Guide at 62-63. In obtaining such reasonable assurance that a proper allowance for loan losses, in fact, has been

recorded, the Bank Audit Guide describes the basics of the independent auditor's duties succinctly in four paragraphs (at 63-64). These paragraphs are quoted below:

The principle purpose of the audit procedures performed by the CPA is to identify individual loans or conditions that require further consideration in evaluating the reasonableness of the allowance. Factors include:

- o Current trend of delinquencies.
- o Loans classified by supervisory agency examiners.
- o Excessive loan renewals and extensions.
- o Absence of current financial data related to borrowers and guarantors.
- o Borrowers experiencing such problems as operating losses, marginal working capital, inadequate cash flow, or business interruptions, such as involuntary conversions due to fire loss or condemnation.
- o Loans secured by collateral that is not readily marketable or is susceptible to deterioration in realizable value.
- o Loans in industries experiencing economic instability.
- o Inadequately documented loans.

The CPA is not required to ascertain the collectibility of each individual loan included in a bank's portfolio. The audit procedures should be designed to determine the overall collectibility of the entire portfolio and should be performed primarily on a test basis. In establishing the scope of the work to be performed, the CPA should consider the composition of the loan portfolio, growth trends being experienced in specific loan classifications, previous loss and recovery experience, including timeliness of

charge-offs, the existence of sound lending policies and procedures, management's procedures for loan review and classification, and subjective factors, such as economic and environmental conditions.

* * * * *

Loan categories represented by large volumes of relatively small loans with similar characteristics, such as real estate mortgages, installment loans and retail credit loans are generally evaluated on a "pool" basis. The CPA is generally more concerned with the effectiveness of and adherence to sound procedures related to such loans than with a critical appraisal of each individual loan. Unless unusual circumstances exist, the testing of procedures and review of delinquency status reports should permit a conclusion to be drawn about the adequacy of the allowance required for those loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

Conversely, an evaluation of time and demand (commercial) loans normally requires a more detailed review, since the amount of individual loans is generally large and the types of borrowers and the purposes of the loans may be dissimilar. A relatively small number of potential losses can often significantly affect the adequacy of the allowance. The CPA in those circumstances may select and review a certain number of loans in excess of a certain amount with particular attention to problem loans previously identified by the bank's internal review procedures, the auditor's prior experience and loans commented on by regulatory authorities. Loans selected for review may be further stratified by type of loan, such as construction loans, floor plan loans, working capital loans, or loans to a specific class of business, depending on the CPA's assessment of the relative exposure to loss presented by the various categories.

5. Accounting for the tax effects of the allowance for loan losses. Under GAAP, banks are required to record income tax expense based on income and expense items reported in the statement of income for the period. Timing differences (differences between the periods in which transactions affect taxable income and those in which they enter into the determination of pretax accounting income) originate in one period and reverse or turn around in one or more later periods. Under Accounting Principles Board Statement No. 11, the tax effect of a timing difference is measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between book and tax income. The tax effect is accounted for under the deferred method of tax allocation. A deferred credit is created when book income exceeds taxable income, and a deferred debit is created in the converse situation. The deferred debits and credits reported on the balance sheet represent the cumulative recognition given to timing differences and are not receivables or payables in the usual sense.

The difference between the additions to a bad debt reserve for tax purposes and additions based on GAAP is a frequent timing difference for banks. In years in which a bank has book income, deferred tax debits are generated for any excess of the financial statement provision for loan losses over the tax bad debt deduction. A deferred credit is created when the tax provision exceeds the book provision for loan losses.

Under the Treasury proposal, the book bad debt expense may well exceed the tax bad debt expense in many years. As indicated above, this will generate a deferred debit. This asset can be left on a bank's balance sheet as long as it embodies a probable future benefit to the bank (i.e., the book-tax timing difference will reverse and the bank will be able to use the debit to offset its current tax liability to the government). However, in the situation where a bank has deferred tax debits on its balance sheet and then reports a book loss, the deferred debits would

have to be reevaluated as to their probable future benefit. If the bank's loss condition is viewed as other than purely temporary, the deferred tax debits would have to be written-off. These write-offs could exacerbate the already poor financial condition of the financial institution in question.

B. Regulatory Requirements.

1. The regulatory system and reporting requirements.

Commercial banking in the U. S. operates under a dual system -- a bank can obtain either a Federal or a state charter. National banks operate under Federal charters and are supervised by the Office of the Comptroller of the Currency (the "Comptroller"). They are required to be members of the Federal Reserve system and to have their deposits insured by the Federal Deposit Insurance Corporation (the "FDIC").

State banks are supervised by banking departments of the chartering states, but most state banks are also subject to some form of Federal control. Although a state bank is not required to join the Federal Reserve system, it may do so. If it joins, it must also subscribe to the FDIC. A state bank that joins the Federal Reserve system is regulated by the Federal Reserve. Generally, it will also be examined by state banking examiners. If it does not join, it still has the option of obtaining FDIC coverage. A state bank that belongs solely to the FDIC is regulated by the FDIC and also typically by state banking regulators.

Over 90 percent of the banks in the U. S. are insured by the FDIC. Thus, over 90 percent of the banks are subject to some form of Federal regulation, and the state banks among them to some form of state regulation as well. The remaining 10 percent of the banks are all regulated by state authorities.

The three Federal bank regulators require banks under their supervision to file "Reports of Condition and Income" ("Call Reports") quarterly. The Call Report must be prepared based on the instructions approved by the Federal Financial Institutions Examination Council (hereinafter "FFIEC Rules"). The FFIEC Rules provide that while it is the regulators' intention to follow GAAP wherever these principles are appropriate, the Call Report is a supervisory and regulatory document, not primarily an accounting document. Hence, the FFIEC Rules do not in all cases follow GAAP. Nevertheless, the FFIEC Rules do follow GAAP with respect to the allowance for loan losses.

For example, the FFIEC Rules state that as of the end of each quarter (or more frequently if warranted), the management of a bank that is required to be on an accrual basis (all banks after January 1, 1985) must evaluate, subject to examiner review, the collectibility of the loan portfolio and make appropriate entries to bring the balance of the loan loss allowance to a level adequate to absorb anticipated losses. Moreover, management must maintain reasonable records in support of their evaluation and entries. In addition, the FFIEC Rules also state that charges against and credits to the loan loss reserve must be made in accordance with GAAP. Thus, GAAP and the regulatory standard are one and the same.

2. Regulatory examination procedures. While Federal regulators appraise the adequacy of a bank's allowance for loan losses within the context of GAAP, the examination procedures vary from agency to agency. Because of the importance of loan losses to the safety and soundness of any bank, examiners are directed to spend substantial time in this area in completing their supervisory examination. The Comptroller's rules for the examination of loan loss reserves are discussed in detail below in order to illustrate the steps that a bank examiner is expected to take in conducting an examination of this area.

Following this detailed examination of the Comptroller's rules, a much briefer review is made of the rules of the Federal Reserve and the FDIC. While the latter rules differ in some respects from the rules of the Comptroller, the differences are not sufficiently material to warrant a detailed discussion of all three sets of rules.

a. Comptroller's guidelines for examining loan loss reserves. The Comptroller's guidelines are set-out in the "Comptroller's Handbook for National Bank Examiners" (hereinafter, the "Comptroller's Handbook"). As the quoted material below from the Handbook will show, there are many similarities between the Comptroller's guidelines for its examiners and the guidelines for independent auditors set forth in the Bank Audit Guide.

The Comptroller's Handbook starts by advising examiners to review historical data, including but not limited to (at §217.1, p.2):

- o Amount of loans at the most recent review date and at comparable dates in prior years.
- o Amount of valuation allowance at the most recent review date and at comparable dates in prior years.
- o Provisions for possible loan losses for the past several years.
- o Excess or deficiency of provision for possible loan losses over actual amount of such losses for the past several years.
- o Loan loss experience, charge-offs and recoveries, in the past several years in total and by major loan categories.
- o Ratios of net charge-offs to average loans for several years.
- o Ratios of allowance for loan and lease losses to average loans for several years.

Because historical data is backward looking and may not accurately reflect the current condition of a bank's loan loss reserve, the Comptroller's Handbook then advises its examiners to look beyond historical data (at §217.1, p.2):

Historical data, whether expressed as amounts or ratios, or formulas based on such data, however, provide only a portion of the information necessary to evaluate the adequacy of the allowance. An assessment of the effectiveness of the bank's lending policies and procedures and any changes relating thereto is equally important. Such information, combined with the results of periodic comprehensive reviews of the loan portfolio, provides a sound basis for estimating loan losses and assessing the effect of current economic conditions and other factors on the applicability of historical data in projecting trends.

In looking beyond the historical data, the examiners are to "evaluate management's estimate of losses existing in the bank's portfolio" and to review "the procedures used in making that estimate." 1d. In particular, the examiner is directed to look at the following information gathered in the course of his or her examination (at §217.1, p.3):

- o Evaluation of lending policies, practices and internal controls.
- o Loans classified and commented on in the current examination, including those on management's list of loans deemed less than 100 percent collectible.
- o Current trend of delinquencies.
- o Listings of aged past-due loans, loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing the interest rates or deferring interest. Such listing should include borrower's current financial conditions, collateral value and any third party reliance.

- o Excessive loan renewals and extensions.
- o Results of discussions with bank officers and employees.
- o General or local economic conditions that might have a bearing upon the collectibility of loans, such as pronounced business depression, closing of a large number of plants in an industry, widespread labor strikes or international trade barriers because of war or exchange restrictions.
- o All available outside information of comparable nature regarding banks with similar loan portfolios of similar size, composition, and quality. Id.

Peer group information is, however, to be used with caution since losses "may vary greatly even among banks with loan portfolios of similar size, composition and quality." Id.

As part of her or his examination, the examiner is directed to classify "criticized" credits into four categories. These classifications and the Comptroller's Handbook's description of them are (at §215.1, pp.1-2):

- o Other Assets Especially Mentioned (OAE) -- Assets in this category are currently protected but are potentially weak. These assets constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

* * *

- o Substandard Assets -- A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss

potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard.

- o Doubtful Assets -- An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

* * *

- o Loss Assets -- Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Based on these classifications, the loan loss reserve should be sufficient "to cover those loans classified as loss in the report of examination, some applicable percentage of other classified loans ... estimated potential losses on the loans not classified during the current examination... [and] some applicable amount of the accrued interest on the loan portfolio." As for "other classified loans" (i.e., those other than "loss" assets), the examiner is to make an "estimate of loss applicable to specific, adversely classified loans ... where possible." Reserves for all other loans are to be based on historical data and the examiner's judgment of the current collectibility of the loans in question. Comptroller's Handbook at §217.1, p.3.

The Handbook also provides a convenient example of the use of the four classifications of "criticized" loans in deriving an appropriate loan loss reserve (at §215.1, p.2):

An example of proper utilization of the doubtful category is the case of a company being liquidated, when the trustee-in-bankruptcy has indicated a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In that situation, estimates are based on liquidation value appraisals with asset values yet to be realized. By definition, the only portion of the credit which is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful and 35 percent loss.

By following audit guidelines that are very similar to those set forth in the Bank Audit Guide and properly classifying problem loans, the examiner is to "reasonably assess" the loan loss reserve established by management. Because both the independent auditor and the bank examiner are being guided by GAAP and using similar audit guidelines, they should reach similar conclusions about the adequacy of a bank's loan loss reserves.

b. Other regulatory guidelines for examining loan loss reserves. The FDIC publishes its guidelines to its examiners in a volume entitled "Manual of Examination Policies." The emphasis in these guidelines is on the quality of an institution's loan portfolio (as opposed to the adequacy of its reserve), but the examination procedures are much the same as those discussed in the preceding section. See Manual of Examination Policies 9A (and, in particular, Parts III and IV). The Federal Reserve examiner's instructions for reviewing the allowance for loan losses are contained in section 403 of the Supervision Manual of the Division of Banking Supervision and Regulation. The provisions here are more general than those contained in the Comptroller's or FDIC's handbooks but generally are of the same tenor.

3. Regulatory sanctions. In addition to the ability to examine banks and bank holding companies under their supervision, Congress has given the Comptroller, the FDIC and the Federal Reserve powers to sanction banks and bank holding companies for engaging in certain practices, including (amongst other things) violating their regulations concerning the maintenance of adequate loan loss reserves. These powers were given to the regulators in two separate legislative acts.

First, Congress enacted the Financial Institutions Supervisory Act of 1966 ("FISA"). FISA empowered the three Federal bank regulators to institute cease-and-desist order proceedings where a bank was engaged, or was about to engage, in unsafe or unsound practices, violations of law or regulation, or violations of agreements with (or written conditions imposed in connection with applications granted by) the bank regulators. In a cease-and-desist order, the regulator not only can enjoin such conduct but also can direct the bank "to take affirmative action to correct the conditions resulting from any such violation or practice." The regulators also were empowered, under narrowly defined circumstances, to remove from office any bank officer or director.

In 1978, Congress enacted the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRIRCA"). FIRIRCA gave the regulators expanded cease-and-desist and removal powers, granted the Federal Reserve the power to order bank holding companies to terminate non-bank activities that might pose a threat to an affiliated bank, and gave the regulators authority to assess civil money penalties for violations of most of the important laws and regulations governing the activities of financial institutions.

While procedures differ somewhat among the three regulators, each typically employs a range of sanctions tailored to the severity of a

particular case. At the least formal end of the spectrum are "informal" agreements executed at the regional level. These take the form of a memorandum of understanding at the Comptroller and a letter agreement at the FDIC. The regional Federal Reserve Banks have similar authority to enter into written agreements, subject to the approval of the Board's director of the Division of Banking Supervision and Regulation and its general counsel. Cease-and-desist proceedings are instituted for the most serious problems.

The regulators also impose a variety of remedial measures. These measures include plans for corrective action, improved procedures and controls, curing violations of law, dividend prohibitions, prohibition on certain loans and activities, and special audit and compliance committees.

V. EVALUATION OF TREASURY PROPOSAL AND GAAP RECOMMENDATION

The recommendation made in this report is that the allowance for bad debts be guided by GAAP for book, tax and regulatory purposes. The Treasury proposal, on the other hand, is to use the specific charge-off method for tax, while at the same time employing GAAP for book and regulatory purposes. This section of the report evaluates the Treasury proposal and the recommendation made herein in light of the stated goal in the Treasury Report of having an economically neutral tax system.

A. Economic Analysis. The economic data on bank bad debt experience is largely contained in the information filed in the Call Reports. This information is then collated and published by the FDIC in its annual report entitled "Bank Operating Statistics" (hereinafter, "Bank Statistics"). Although an analysis of this data does not permit absolutely precise answers on the proper treatment of bad debts needed to have an economically neutral tax system, some reasonable conclusions can be drawn.

1. The data. We have analyzed data from Bank Statistics and related sources back to 1970 and have extrapolated certain information from these statistics. Based on this work, we prepared the following schedules reflecting the banking system as a whole:

- a Allowance for loan losses under GAAP from 1973 through 1983, including total loans outstanding, the loan loss reserve and charge-off data.
- b Allowance for loan losses under a six-year moving average method over the same period, reflecting the bad debt expense permitted by this method and related data.
- c Ratios derived from the foregoing schedules, including reserves to loans (under GAAP and six-year moving average), reserves to net charge-offs (under the same two alternatives), net charge-offs to total loans (same percentage for both methods), and recoveries to gross charge-offs (also, same under both methods).

The above schedules can be found in Exhibits C, D and E, respectively, appended to this report.

An analysis of Treasury's proposal and three reserve methods (the percentage method, the six-year moving average method and GAAP) utilizing the above schedules is made below.

2. Treasury's specific charge-off proposal. As indicated at the beginning of this memorandum, the Treasury proposes to eliminate entirely the reserve method and go to a specific charge-off method. The stated basis for this proposal is that bad debt reserves distort taxable income by accelerating deductions without properly reflecting them on a discounted basis. We believe that this notion about improperly accelerating deductions is mistaken and that a persuasive case can be made for matching bad debt expense against the gross income associated

with it in deriving a taxpayer's true economic income. This argument is set forth in Section V, B, 1 below. We also believe that the GAAP proposal properly associates bad debt deductions for tax with the time when they occur economically.

Before turning to an evaluation of several possible reserve methods, we believe that an example justifying the Treasury proposal found in the Treasury Report, Vol. 2 at 219-220 should be addressed. This example is used by Treasury to explain why bad debt reserves purportedly accelerate bad debt deductions improperly. The essential facts of the example, which evidently involves a manufacturing concern and not a bank, are as follows (the full text of the example may be found in the Treasury material contained in Exhibit A). A new firm starts business and at the end of the year it has \$1,000 of accounts receivable and "in the first year has \$10 of bad debts (an experience rate of one percent)." Thus, under the bad debt reserve method which this accrual basis taxpayer adopts, the "first year bad debt deduction is \$20 -- \$10 of actual losses plus \$10 for the increase in the allowable reserve." This result, Treasury argues, is unfair; the implicit (and perhaps unintended) notion being that a \$20 expense has been claimed against \$1,000 of gross income when the taxpayer had only a bad debt loss rate of one percent.

However, a further analysis reveals a different picture. The taxpayer in the example must have had \$2,000 of gross income (\$1,000 of receipts on which \$990 was paid during the year, establishing the one percent loss rate, and \$1,000 of receivables still unpaid at year's end). Against the \$2,000 of receipts, the taxpayer will never collect the \$10 written-off and reasonably expects never to collect the \$10 reserved against. Under these facts, we believe that the taxpayer's true economic income is best reflected by a \$20 bad debt expense (and not the \$10 expense Treasury would like to see). Indeed, we feel that this example as analyzed above illustrates the proper matching of income and expense brought about by the reserve method of accounting.

As illustrated by this example, the key failure of Treasury's proposal is that it postpones the recognition of a bad debt loss until the standard in the tax law permitting the write-off of a loan is satisfied. That standard requires a taxpayer to establish by objective evidence that a debt is destitute of value, valueless or useless. See, e.g., Higginbotham-Bailey-Logan Co., 8 B.T.A. 566, 578-579 (1927), acq. in part, nonacq. in part, VII-1 C.B. 14, 38. A taxpayer typically will not be able to satisfy this standard until well after it has suffered a bad debt loss economically.

3. Various possible reserve methods. The current law permits banks to use a percentage or six-year moving average reserve method. The recommendation of this report is to use a loan loss reserve based on GAAP. We discuss the relative consonance of these three methods with the Treasury's espoused goal of an economically neutral tax system in the material below and in Section V, B, 3, which follows.

The percentage method -- now set at 0.6 percent of eligible loans and due to expire after 1987 -- could only be economically justified by circumstances leading to an actual net charge-off rate compared to eligible loans of 0.6 percent. Even then, this would only be an average rate and would not match the experience rate of individual banks. The ratios contained in Exhibit F show that the average net charge-off to total loans ratio was between .5 percent and .7 percent four times during the years 1975 through 1983. This percentage would have increased if "ineligible" loans (as those loans are described in section 585(b)(4) of the IRC) were subtracted as the current law requires from the total loans denominator figure used in Exhibit E (the information contained in Bank Statistics did not permit this to be done). Thus, the percentage method may be justified by its ease of use, but it may not be an accurate measure to reflect exactly the economic bad debt losses of different institutions.

This leaves the moving average and the GAAP reserve methods to be compared. The moving average method is designed simply to permit a reserve equal to the expected loan charge-offs that will be incurred over the next 12 months based on the taxpayer's current experience and its experience in the preceding five years. We believe that the moving average system generates an erroneous loan loss reserve balance for any taxpayer that has a collection cycle (as defined below) of more or less than 12 months. Most banks have a collection cycle greater than 12 months (see the discussion that follows). Because the reserve balance will typically be wrong for a bank, the bad debt deduction permitted against income under a moving average system also will be in the wrong amount except in fortuitous circumstances.

The meaning of a collection cycle is best defined by means of an example. If a bank makes a four year loan to a borrower that becomes a troubled loan in year two, the chances are that the bank will work with the borrower for several years before the bank can determine whether the loan will be paid in full, in part or not at all. However, the bank incurs its economic loss in major part at the time the loan becomes a troubled loan. In reflection of this loss, a reserve for the amount the bank believes uncollectible based on the current economic condition of the borrower will typically be placed against this troubled loan. The loan will not be written-off (in full or in part), however, until the effort to work with the borrower is complete. At that time, a write-off will be taken in the amount of the reserve or in a greater or lesser amount depending on what the borrower actually pays. The period from the establishment of the reserve to the payment date is hereinafter referred to as the "collection cycle." The collection cycle is influenced by the maturity of the loans reserved against and by the length of time taken by the bank to deal with a troubled loan.

A reserve is an accurate reflection of economic reality if it covers the losses inherent in a loan portfolio. Thus, if a bank stopped making any additional loans, its reserve should be adequate to cover the net charge-offs it makes as its loan portfolio is paid-off. In a more typical situation where a bank continues to make loans, the reserve should be adequate to cover the net charge-offs it makes over the collection cycle. This being the case the ratio that best measures the accuracy of a loan loss reserve is the ratio by which the loan loss reserve exceeds net charge-offs. If a bank's collection cycle is two to three years, the reserve should exceed net charge-offs by a multiple of two to three. More specifically, if a bank's net charge-offs were \$500,000 per year and its collection cycle were three years, its reserve should be about \$1,500,000 (a ratio of three to one).

If a reserve balance is adequate to cover the expected net charge-offs of a bank over its anticipated collection cycle, then the bad debt expense allowed in maintaining this reserve will match properly the interest income and the bad debts economically associated with that income. Any reserve method consistently resulting in a reserve balance materially different from a reserve balance that associates net charge-offs and the collection cycle in the above fashion typically will not result in a proper matching of income and expense. An example illustrating this point is annexed hereto as Exhibit F.

The next question then is, what is the typical collection cycle for banks? There appears to be no precise information on this point. We know, however, that banks are generally short to mid-term lenders. This would normally involve maturities of two to five years. The one scholarly study on the topic we have been able to find concluded that banks had an appetite for credits of about four years. See W. Terrell and W. Fraser, Jr., "Interest Rates, Portfolio Behavior and Marketable Government Securities," XXVII J. of Finance (March 1972) at 16. We also

know that loan work-outs typically take from one to three years. Based on this information, we believe a collection cycle of somewhere between two to three years for banks is reasonable.

We turn now to the reserve to net charge-off ratio contained in Exhibit E. A nine year comparison of these ratios under GAAP and under the six-year moving average method is set-forth below:

Year	Reserve to Net Charge-Off Ratio	
	GAAP	Moving Average
1983	1.822	.658
1982	1.272	.690
1981	3.033	1.061
1980	2.793	1.089
1979	3.582	1.438
1978	3.187	1.346
1977	2.465	1.049
1976	1.812	.716
1975	1.900	.583

In light of this data, we find that for the banking system as a whole the six-year moving average method would have generated a reserve of sufficient size to cover only a portion of the actual charge-offs in both 1982 and 1983. For example, the moving average reserve balance at the end of 1982 covered only .658 of the net charge-offs made by banks in 1983. On the other hand, the GAAP reserve is adequate to cover approximately two to three years of net charge-offs in a loan portfolio with a collection cycle of about two to three years. While the data is not readily available to establish the collection cycle for commercial banks, a collection cycle of at least two to three years is reasonable. Accordingly, the GAAP method more nearly matches the predicted collection cycle of commercial banks than any moving average method.

Based on the foregoing, the GAAP proposal will more nearly give a proper bad debt reserve for a bank than any moving average method. Because the GAAP method will consistently result in a proper reserve balance for banks, it will also produce a bad debt deduction against income that more nearly matches economic reality than any moving average method.

B. Evaluation of Treasury's Proposal

1. The proposal is inconsistent with proper accrual accounting.

As stated previously, the Treasury Report argues that bad debt reserves distort taxable income because the reserve method allows a deduction for estimated future losses without discounting these losses back to their present value. This argument appears to be wrong both in theory and when considered in light of actual practices in the banking industry.

To begin with, the fundamental justification for the use of the loan loss reserve method is that it properly matches current period expenses against current period income. As discussed in Section IV,A above, GAAP requires that a reserve method be used because without its use, the income of a bank might be materially misstated. On any loan made by a bank involving the risk of nonpayment (loans to the Federal government generally are viewed as being risk free), the lending institution charges a rate of interest designed to compensate it for the borrower's use of the funds plus an amount to compensate it adequately for the risk that the loan may not be repaid promptly. The interest income is accrued on an annual basis. If a bank's bad debt expense is not offset against it until a loan is actually written-off, the bank's interest income will not be properly matched with an expense that is economically associated with it.

Second, the Treasury proposal is based on the notion that if a bank makes ten loans, each with a maturity of five years, the bank's bad debt

deduction in year one will be equal in amount to the total principal amount of these loans that will be written-off over the next five years. Treasury concludes that this is unfair because these losses should be discounted back to their present value before being deducted. However, the basic premise underlying this conclusion simply is not true. If the bank's reserve is determined on some moving average experience formula akin to the Black Motor formula, the bank's bad debt deduction in any one year would approximate the amount based on historical averages that actually will be charged-off sometime during the next 12 months. Assuming an even flow of write-offs over this 12 month period, the discounting the Treasury seeks would be, at best, for a period of six months. Furthermore, the discounting argument assumes that a bank's economic bad debt loss occurs on the date a loan is written-off. In fact, the economic loss occurs well before that date. If the bank's reserve is determined under facts and circumstances guided by GAAP, the amounts typically reserved against are those where there is currently reason for concern that the borrower may not be capable of adequately servicing its borrowings. Banks do not set-up reserves in the year a loan is made for the principal amount that may not be paid sometime in the distant future. Rather, the bad debt reserve of a bank and the current bad debt expense being claimed to sustain that reserve are designed to cover the current infirmities in a loan portfolio and not some diminution in the value of assets that might possibly happen in the future. Stated differently, the bad debt reserve reflects the economic losses that have already been or will be shortly sustained.

Finally, Treasury's proposal on bad debt reserves is inconsistent with its advocacy elsewhere that most taxpayers be forced to abandon the cash method of accounting and move to the accrual method. Treasury Report, Vol. 2 at 215-217. For banks, the Treasury Report seems designed to place them on the accrual basis of accounting for their income and the cash basis of accounting for a significant element of their expenses.

This appears to amount to an improper hybrid method of accounting. Cf. Reg. §1.446-1(c)(1)(iv).

Given the foregoing facts and arguments, we believe that it is appropriate for banks to be given a current deduction for additions to their bad debt reserves.

2. The proposal is inconsistent with government regulatory objectives. As discussed in Section IV.B, current regulatory practices require banks to maintain bad debt reserves in an amount equal to the amount determined under GAAP. This regulatory policy is designed to protect the safety and soundness of the banking system. But it is not designed to set-up reserves for loans that appear perfectly sound and possibly might have to be written-off years in the future. Thus, the regulatory policy is intended to create an economically sound banking system based on proper accrual concepts of accounting.

Although obviously not intended to lead to an unfortunate result, the Treasury proposal to require banks to use the cash method of accounting for loan losses may thwart the sound regulatory objectives discussed above. In particular, where bank management is advised, on the one hand, to maintain adequate bad debt reserves but is told, on the other, that it will not be allowed a tax deduction for additions to these reserves, management may be discouraged from satisfying the former objective. There is no good reason for this conflict. The regulatory objectives are not inconsistent with sound accrual accounting policies, and there is no reason not to use these policies for tax purposes as well.

3. The proposal does not create a "level playing field." A fundamental principle underlying the Treasury's tax proposals is that "an ideal tax system should be as neutral as possible toward private decisions." Indeed, "[a]ny deviation from this principle ..." would

constitute "an invidious form of industrial policy ..." Treasury Report, Vol. 1 at 13. Under these principles, scarce capital resources would be allocated fairly between the different bidders in the market place for capital because each of these consumers of capital would be paying tax at the same rate on their economic income.

There is, however, a basic flaw in Treasury's argument as concerns commercial banks and other financial institutions. The bad debt deduction of a bank calculated by using the reserve method is necessary in determining a bank's true economic income. The regulatory authorities believe this to be so as do the thousands of producers and consumers of published financial statements. The Joint Committee Study also seems to have reached this conclusion. The Treasury proposal is directly contrary to this fundamental fact.

At the same time, other taxpayers are to be permitted to index inventories and capital assets to bring their taxable incomes more closely in line with their economic income. These adjustments, while theoretically available to banks, will in most instances not be materially important to them. Similarly, while all taxpayers are to be deprived of the reserve method of calculating bad debt deductions, this deduction is not nearly as significant to taxpayers that are not financial institutions. Thus, we believe that the result of the Treasury proposal is to "tilt" the "playing field" unfairly at the expense of financial institutions.

4. The proposal will heighten disputes between taxpayers and the IRS. One of the problems leading to the enactment of legislation in 1921 authorizing the reserve method of accounting for bad debts was the disputatious nature of the decision to write-off a debt in its entirety. Was the debt truly bad? When did it go bad? Was it this year or a prior year? Cf. IRC §6511(d)(1) [special seven-year period to file refund

claims relating to bad debts because of the difficulty in determining when a debt has gone bad). Although these issues cannot be avoided altogether, the reserve method of accounting tends to reduce the volume of these arguments to a manageable level.

5. The proposal may create large and unfortunate book-tax timing differences. Because the Treasury proposal will often postpone the deduction of bad debt deductions until after they have been economically accrued for GAAP purposes, this timing difference will result in a "prepaid" tax item (i.e., a deferred debit) on the balance sheets of many banks. As stated in Section IV,A,5, this asset will have to be written-off on the books of certain banks if these institutions may not be expected to use this so-called asset in the foreseeable future. Any asset that is written-off results in a charge to book earnings. This reduction in book earnings would be directly attributable to the Treasury proposal.

C. Evaluation of Facts and Circumstances Standard Based on GAAP. The proposal recommended herein is that (i) the reserve method of accounting be retained by commercial banks, and (ii) the bad debt allowance be calculated in accordance with GAAP. The arguments in support of this recommendation are set forth below.

1. The recommendation is consistent with proper accrual accounting. As indicated in the preceding sections, the fundamental precept of accrual accounting is a proper matching of income and expense. This precept underlies GAAP. It also is basic to tax accrual accounting. The reserve method of accounting for bad debts as provided for by GAAP properly matches the interest income being earned by a bank with the bad debt expense associated with that income. The GAAP standard does not accelerate the taking of deductions, and it does not distort current book income by reflecting future expenses at some non-discounted

value. We believe that the recommendation to provide for a tax bad debt reserve based on GAAP will adopt a standard that satisfies the fundamental matching concept.

Moreover, unlike the current provisions applicable to banks, the recommended GAAP standard is not inflexible and will fit the facts and circumstances of each bank. Influenced but not controlled by its past record of charge-offs, a bank will determine what addition should currently be made to its bad debt reserve.

2. The recommendation is not an abrupt departure from existing law. Under the current law, section 166(c) and Reg. §1.166-4(b) provide for a facts and circumstances test for establishing a bad debt reserve for taxpayers not covered by a more specific provision in the tax law. This provision is not now applicable to banks because banks are covered by the separate provisions of section 585. The case law under section 166(c), while being heavily influenced by the Black Motor formula, has allowed for the consideration of a variety of factors in determining the correct addition to a bad debt reserve. See the discussion in Section III.B. These factors have included the use of GAAP standards. See, e.g., Westchester Development Co., supra, 63 T.C. at 205-206. The Service has also recognized that GAAP can play a proper role in determining a tax bad debt deduction. Rev. Rul. 76-362, supra (this ruling cites the Westchester Development case with approval).

The recommendation we are making is that banks be permitted to use a facts and circumstances bad debt reserve akin to the reserve provisions applicable to all taxpayers under section 166(c) and Reg. §1.166-4(b). However, because of the banks' unique status of having their books and records audited by regulators (as well as outside auditors) utilizing GAAP, we are further recommending that any bad debt deduction calculated by a bank be in accordance with GAAP. This recommendation is not an

abrupt departure from current law since there is already authority to permit taxpayers under appropriate circumstances to use GAAP in making additions to a bad debt reserve. It is simply a recommendation that GAAP be officially recognized as an appropriate standard for banks given the peculiar facts and circumstances of the banking industry.

3. The recommendation is consistent with regulatory standards, which we believe the tax law should follow. Section IV.B discusses in detail the regulatory provisions applicable to bad debts. As stated there, the regulatory standards incorporate GAAP. Using this standard, the regulators make their own independent determination of the adequacy of a bank's loan loss reserve. The bad debt measure we are recommending would be keyed to the standard being used by substantially all of the bank regulators. Accordingly, it would be reflective of their independent judgment. Equally important, because it would be consistent with the regulatory guidelines, it would encourage bank management to keep adequate reserves to ensure the safety and soundness of the banking system. The Treasury proposal, on the other hand, would work at cross purposes to these regulatory guidelines.

The IRS generally has not treated regulatory accounting practices as binding for tax purposes. See, e.g., Rev. Rul. 66-220, 1968-1 C.B. 194. Nevertheless, there is authority that regulatory policies are to be accorded deference. See, e.g., Comm'r. v. Idaho Power Co., 418 U.S. 1, 15 (1974). This has been particularly the case where the timing of loan charge-offs or the nonaccrual of interest by a financial institution has been in question.

Reg. §1.166-2(d)(1) provides that loans written-off in response to the orders of regulatory authorities or in accordance with established regulatory policies (the charge-off of which is later confirmed in writing by the regulators) will be conclusively presumed to be

worthless. Further, in Rev. Rul. 81-18, 1981-1 C.B. 295, the IRS followed the rules of the Federal Home Loan Bank Board as to the write-off of accrued interest on a loan where the interest was due and unpaid for a period of more than 90 days. See also, Rev. Rul. 84-94, 1984-1 C.B. 34 (loan to a foreign debtor will be treated as worthless for tax purposes if subject to an "allocated transfer risk reserve" prescribed by a bank regulator).

The question of when a loan should be charged-off or the point when no additional interest on a loan should be accrued both involve the same type of judgment as is involved in determining the adequacy of a loan loss reserve. The tax law permits or invites the use of regulatory guidelines in the first two cases. There is no good reason why regulatory provisions should not also be accorded deference in the case of loan loss reserves.

4. The recommendation will create a standard that is consonant with Treasury's goal of economic neutrality. The GAAP standard is designed to present a fair reflection of a bank's financial condition to its owners, creditors and other interested segments of the public. It obviously was not designed to give banks a tax preference at the expense of other taxpayers. Consequently, its use as the standard of loan reserves for tax purposes would not give rise to a "tax-expenditure." Moreover, we believe that the GAAP standard is a better measure of economic reality than (i) the percentage method recognized under current law until 1988, (ii) the six-year moving average method also recognized under current law, or (iii) Treasury's proposal to change the law to the specific charge-off method.

When originally adopted, the percentage method was to replace a 20-year moving average method that had become outdated by the incorporation of depression years' data. The method was easy to use and an improvement

under the circumstances to the 20-year moving average method. Because of its use of an uniform percentage, it probably is not an accurate measure of economic reality for all banks.

The six-year moving average method has infirmities as well. As discussed before, this method gives nothing more than an actuarial prediction as to the loan charge-offs that will occur sometime during the next 12 months. It is a prediction based on the past facts and circumstances of a bank and does not take into account the current facts and circumstances of the institution. Thus, recent changes in policy by an institution, shifts in the make-up of a loan portfolio, or changes in the economy will be only dimly reflected by the six-year moving average method.

The Treasury's proposed specific charge-off method is probably the least satisfactory of the alternatives noted above. It makes no attempt to match bad debt expense against the interest income related to it. Instead, it rejects any matching effort on what we believe to be the mistaken notion that reserves represent future loan losses "without any discount for the present value of such losses." Treasury Report, Vol. 2 at 218-219.

In light of the foregoing, we believe that the GAAP standard recommended herein would bring the tax treatment of bad debts into the closest conformity possible with economic reality. Consequently, it should assist in leading to the single most important goal of the Treasury proposal -- that of creating a neutral tax system based on concepts of economic income.

5. The GAAP standard is sufficiently objective for tax purposes. For the reasons discussed below, we believe that the GAAP standard is sufficiently objective to be valid for tax purposes.

To begin with, irrespective of what measure is ultimately adopted, the question of when a bad debt deduction is taken is one of timing. As discussed previously, the collection cycle for an average bank appears to be two to three years. Also, banks generally do not extend long-term credits. These two factors taken together mean that the "turn-around" period for the timing differences involved here should not be lengthy.

Second, bank management will have little motive to overstate reserves. Most managers (whether they be in the banking field or elsewhere) are not eager to diminish book earnings, and earnings must suffer if a bank's reserves are overstated. Indeed, the Treasury Report recognizes in its proposals dealing with LIFO inventory accounting that business managers are frequently reluctant to modify financial statement net income figures simply to obtain a tax deduction. Treasury Report, Vol. 2 at 189-192.

Third, the GAAP figures prepared by management always will be subject to third party audit by the bank's regulators. In the vast majority of cases, they will also be scrutinized by a bank's outside auditors. In addition, the figures will be closely reviewed by creditors, credit rating agencies and bank analysts, all of whom have an interest in and critical ways of reviewing a bank's bad debt reserve. Thus, even before the IRS begins its audit process, the typical bank's bad debt figures will have been "audited" by a number of disinterested parties.

Given the combination of (i) the relatively short-term nature of the timing difference involved, (ii) management's natural reluctance to diminish book earnings, and (iii) the third party reviews of a bank's bad debt figures, the significance of the IRS' audit to the process of determining a bad debt figure that is in keeping with the actual bad debt expense of a bank should be nominal.

VI. CONCLUSION

Based on the analysis made in this report, we recommend that commercial banks should be permitted to continue to use the reserve method of treating their bad debts. We further recommend that the computational methods for commercial banks contained in the present law be replaced by a standard based on GAAP and regulatory requirements (which are synonymous with GAAP in this area). The basis for our recommendation may be summarized as follows:

- o The reserve method of accounting for bad debts properly matches the bad debt expense with the interest income to which it relates.
- o The method of computation suggested is not an abrupt departure from existing law.
- o The recommended method is consistent with bank regulatory standards designed to make for a safe and sound banking system.
- o The recommended method should give a truer measure of economic income than Treasury's own proposal and, thus, further Treasury's goal of creating an economically neutral tax system.
- o The recommended method is sufficiently objective to be valid for tax purposes.

Peat, Marwick, Mitchell & Co.
Bank Administration Institute
New York Clearing House
Association

Dated: April 22, 1985
New York, New York

REPEAL RESERVE METHOD FOR
BAD DEBT DEDUCTIONS

General Explanation

Chapter 10.04

List of ExhibitsExhibitDescription

A	Text of the Treasury Report dealing with bad debt reserves
B	Portion of Joint Committee Study pertinent to bank bad debts
C	Allowance for loan losses under GAAP (1975-1983)
D	Allowance for loan losses under six-year moving average method (1975-1983)
E	Ratio analysis of bad debt reserves (1975-1983)
F	Illustration of a bad debt computation under GAAP, a three-year moving average system, and a specific charge-off method

Current Law

Taxpayers other than depository institutions may deduct a business bad debt in the year in which it becomes wholly or partially worthless. In lieu of deducting specific bad debts, a taxpayer may create a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the taxpayer may deduct an addition to the reserve sufficient to bring it to a reasonable level. The purpose of the reasonable reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that must be added to the reserve to restore it to an appropriate level. The deduction for additions to a bad debt reserve effectively allows a deduction for debts that become worthless during the year plus a deduction for future bad debts (attributable to the increase in the amount of receivables held at year-end.)

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer of property in the ordinary course of its trade or business. In the case of certain taxpayers who were in existence in 1965, a suspense account arrangement prevents allowance of a double deduction by reason of a change in law which took place at that time.

Special rules govern the tax treatment of bad debts of depository institutions; these rules are dealt with in Chapter 12.01.

Reasons for Change

The reserve method for bad debt deductions of non-financial businesses allows taxpayers to deduct the bad debt losses in the current year and to deduct any net increase in the reserve. The deduction for the increase in the reserve represents a deduction for estimated future loan losses arising from an increase in the level of such losses. Moreover, the formula used to estimate such losses bears no necessary relationship to the future losses. The accelerated deduction for future losses defers taxable income and thereby reduces the effective tax rate of a business which experiences an increasing bad debt reserve.

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In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income.

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

Proposal

The deduction for a reasonable addition to a reserve for bad debts would be repealed, although taxpayers would continue to be entitled to a deduction for debts that become worthless or are partially charged off. This proposal would also apply to the bad debts of financial institutions governed by Subchapter H.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to prevent a double deduction for debts that become partially or wholly worthless after the effective date, a taxpayer's outstanding bad debt reserve at the close of the taxable year prior to the effective date would be includible in income ratably over a 10-year period.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. If reserves for future losses are allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Such a system would also require any divergences from the assumptions used in the present value calculation to be corrected. An accurate reserve system is not proposed because of the extreme administrative complexity that would follow.

To illustrate the deferral allowed by the current reserve system, suppose a new firm, shown in Table 1, begins with \$1,000 of accounts receivable and in the first year has \$10 of bad debts (an experience rate of one percent). Under a reserve system where the allowable reserve equals the current year losses, the firm establishes a year-end reserve of \$10. The allowable first year bad debt deduction is \$20 -- \$10 of actual losses plus \$10 for the increase in the allowable reserve. As long as the firm's loss experience does not improve and its level of receivables does not decrease, the excess

deduction is deferred indefinitely. If the firm prospers and accounts receivable increase in year two to \$1,500 with the same loss experience rate of one percent, the allowable reserve increases to \$15 and the company deducts \$20 -- \$5 more than the actual loan losses. In year three, if loans remain the same but the loss experience worsens to two percent, the company can deduct \$45. Finally, if in the fourth year the company experiences a decrease in accounts receivable, its bad debt deduction is less than the loan losses that actually occurred. A net decrease in the bad debt reserve effectively brings excess deductions back into taxable income, thereby ending tax deferral on that amount. Table 1 in Chapter 10.02 shows the reduction in effective tax rate due to tax deferral for given deferral periods and interest rates.

Table 2 shows the discrepancy between bad debt deductions and actual loan losses due to the reserve method. The overstatement of losses and the amount of tax deferral depends on the growth rate of loans and the change in the loss experience rate. Credit growth over the past 10 years for domestic non-financial corporations was in excess of 20 percent annually. The change in the loss experience rate is not known, and is probably cyclical. Yet even with a constant loss rate, bad debt deductions overstated aggregate actual loan losses by 10 percent annually.

Table 1

Hypothetical Example of Excess Deductions with Reserve Method

	Year			
	1	2	3	4
Loss experience rate	1.0	1.0	2.0	2.0
Total loans	\$1,000	\$1,500	\$1,500	\$1,000
Actual losses	10	15	30	20
Beginning reserve	0	10	15	30
End reserve	10	15	30	20
Change in reserve	10	5	15	-10
Bad debt deduction [Losses plus change in reserve]	20	20	45	10
Excess deduction [Deduction minus actual losses]	10	5	15	-10
Accumulated excess deductions	10	15	30	20

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

Table 2

Discrepancy Between Reserve Deductions 1/ and Actual Bad Debt Losses By Change in Total Loans and Loss Experience (In percent)

Annual Percentage Change in Loss Experience	Annual Percentage Change in Total Loans					
	-5	0	+5	+10	+15	+20
-5	-11.2	-4.9	-0.2	3.3	6.0	8.0
0	-4.9	0	3.6	6.3	8.4	10.0
+5	-0.2	3.6	6.4	8.6	10.2	11.4
+10	3.3	6.3	8.6	10.2	11.5	12.5
+15	6.0	8.4	10.2	11.5	12.5	13.3

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Assumes a six-year moving average experience method reserve. Shorter periods would increase the discrepancy.

REPEAL SPECIAL RULES FOR BANK BAD DEBT DEDUCTIONS

General Explanation

Chapter 12.01

Current Law

Commercial banks and thrift institutions are generally subject to the corporate income tax, but receive preferred tax treatment that permits them to deduct additions to reserves for bad debts using a method unrelated to their actual loan loss experience.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository

institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortgage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loan method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Treasury Department proposals would require generally that bad debt losses be deducted only as they occur. See Chapter 10.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for all taxable years beginning on or after January 1, 1986. Depository institutions would be required to include existing reserves in income over ten years, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is to increase the after-tax income of depository institutions. The lower effective tax rate

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resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates. The proposal would eliminate this subsidy.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loan reserve method permits a bank to maintain a reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from \$1.41 billion in 1979 to \$0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 10.04.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are clearly a large subsidy for most savings and loan associations and commercial banks and a significant distortion from the measurement of economic income.

EXHIBIT B

May be obtained from the Committee on Finance

(JOINT COMMITTEE PRINT)

TAXATION OF BANKS AND THRIFT INSTITUTIONS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

MARCH 11, 1983

Prepared for the Use of the
COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION



MARCH 11, 1983

U.S. GOVERNMENT PRINTING OFFICE

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EXHIBIT C

ALLOWANCE FOR POSSIBLE LOAN LOSSES - GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

In Millions	1981	1982	1981	1980	1979	1978	1977	1976	1975
Total Loans	1,299,722	1,207,568	1,115,666	1,002,468	933,043	831,966	722,696	626,932	537,026
Reserve	15,472	13,203	11,415	10,053	9,183	7,957	6,894	6,348	6,161
Loan Loss Expenses	10,755	8,343	5,049	4,479	3,786	3,525	3,301	3,691	3,612
Gross Chargeoffs	10,553	8,153	5,298	4,879	3,763	3,571	3,611	4,190	3,790
Recoveries	(2,063)	(1,594)	(1,535)	(1,280)	(1,199)	(1,074)	(814)	(687)	(547)
Net Chargeoffs	8,490	6,559	3,763	3,599	2,564	2,497	2,797	3,503	3,243

Source: FDIC Bank Operating Statistics, Statistics on Banking, FDIC Annual Reports.

EXHIBIT D

ALLOWANCE FOR POSSIBLE LOAN LOSSES - SIX YEAR MOVING AVERAGE

In Millions	1981	1982	1981	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971	1970
Total Loans	1,299,722	1,207,568	1,115,666	1,002,468	933,043	831,966	722,696	626,932	537,026	543,027	492,362	413,129	366,779	313,713
Net Chargeoffs	8,490	6,559	3,763	3,599	2,564	2,497	2,797	3,503	3,243	3,957	3,159	887	1,087	987
Total Loans - Six-Year Sum	6,190,433	5,813,405	5,232,769	4,654,129	4,196,888	3,754,007	3,335,170	2,959,255	2,645,536					
Net Chargeoffs - Six-Year Sum	27,472	21,779	18,723	18,203	16,561	15,156	13,348	11,836	9,315					
Six-Year Charge-offs to Loans %	.430	.375	.358	.391	.395	.404	.406	.400	.352					
Reserve - % of Total Loans	5,389	4,528	3,994	3,920	3,686	3,361	2,934	2,508	1,890					
Expense - Six-Year Average Method	9,551	7,093	3,837	3,833	2,889	2,924	3,223	4,121						

Calculations: Based on data taken from FDIC Bank Operating Statistics, Statistics on Banking, FDIC Annual Reports.

Loans made in 1988	DESCRIPTION	T & A F & A (\$000's)												
		0	1	2	3	4	5	6	7					
1	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)	100	100	100	195	5	(5w/o)							
	B) Economic loss incurred (\$), continuing loss (\$)			(5)	(2)	(2)								
2	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)		100	100	100	195	5	(5w/o)						
	B) Economic loss incurred (\$), continuing loss (\$)				(5)	(2)	(2)							
3	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)				100	100		100	(95)	5	(5w/o)			
	B) Economic loss incurred (\$), continuing loss (\$)						(5)	(2)	(2)	(5)				
4	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)					100	100		100	(95)	5	(5w/o)		
	B) Economic loss incurred (\$), continuing loss (\$)							(5)	(2)	(2)	(5)			
5	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)							100	100		100	(95)	5	(5w/o)
	B) Economic loss incurred (\$), continuing loss (\$)									(5)	(2)	(2)	(5)	
6	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)								100	100		100		
	B) Economic loss incurred (\$), continuing loss (\$)												(5)	(2)
7	A) Loans made, outstanding \$ paid (\$), written off (\$w/o)											100	100	
Totals	year end principal amount of loans	100	200	205	205	205	205	205	205	205	205	205	205	
	year end economic loss in portfolio	0	(5)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	

Tax computation	Description	T & A F & A (\$000's)							Cumulative
		0	1	2	3	4	5	6	
Interest*	Interest*	5	15	20	20	20	20	20	
	Bad debt deduction/reserve GAAP	0/0	5/5	5/10	5/10	5/10	5/10	5/10	
	3 year moving average	0/0	0/0	0/0	6.7/1.7**	6.6/3.3	6.7/5	5/5	
	Specific charge off	0/0	0/0	0/0	5/0	5/0	5/0	5/0	
Taxable income	Taxable income	5	10	15	15	15	15	15	90
	GAAP	5	15	20	13.2	13.4	13.2	15	95
	3 year moving average	5	15	20	15	15	15	15	100
	Specific charge off	5	15	20	15	15	15	15	100

* Interest is not collected or accrued once the principal balance becomes past due.

** Calculated: Ending reserve balance \$ 1.2
 less: Beginning reserve balance (5.0)
 adjusted for loans written off
 Bad debt deduction \$ 6.7
 Ending reserve balance = \$(3 year write off)
 divided by \$610 (3 year loan balance) multiplied
 by \$205 (end of year 3 loan balance)

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EXHIBIT F
COMPARATIVE RATIOS

	1983	1982	1981	1980	1979	1978	1977	1976	1975
Reserve to Loans GAAP	.0791	.0793	.0723	.0703	.00984	.00956	.00954	.01013	.01147
51+ year Moving Average	.00430	.00775	.00358	.00391	.00395	.00404	.02468	.00400	.00352
Reserve to Net Charge-offs GAAP	1.822	1.272	3.033	2.793	3.582	3.187	2.465	1.812	1.900
51+ Year Moving Average	.658	.690	1.067	1.089	1.438	1.346	1.849	716	583
Net Chargeoffs to Loans	.00653	.00543	.00337	.00359	.00775	.00300	.00387	.00539	.00604

Calculations: Based on data taken from FDIC Bank Operating Statistics. Statistics on Banking, FDIC Annual Reports. All ratios are calculated as a percentage determined by dividing the first factor indicated by the second factor indicated.

Exhibit F

Effect of Collection Cycle
on Bad Debt Reserve and Bad Debt Expense

This example illustrates how a moving average formula will result in a reserve which is less than the economic loss incurred when the collection cycle exceeds one year. It also illustrates how a moving average formula or a specific charge-off method will frequently result in a bad debt deduction that does not match interest income and bad debt expense appropriately.

Assumptions

Loans originated each year:	\$100,000
Portion of loans originated each year ultimately written-off:	\$5,000
Term of loans:	2 years
Collection cycle:	2 years
Economic loss incurred:	1 year after receivable origination
Loans charged off:	3 years after receivable origination
Rate of interest on each loan (interest is collected until maturity):	10 percent

Comparison of bad debt reserve and bad debt expense under the GAAP,
three-year moving average and specific charge charge-off methods. See
the schedule on the following pages.

Conclusions

1. Total economic income over the seven years covered in the example is \$90,000 (interest received of \$120,000, less economic loan losses of \$30,000). Total taxable income determined under GAAP equals this economic income. The three-year moving average method overstates economic income on a cumulative basis by \$5,000; the specific charge-off method overstates economic income by \$10,000 on the same basis.
2. In any single year, the proper bad debt expense will not be associated with interest income under the three-year moving average or the specific charge-off methods except fortuitously when the new loans generated each year, the collection cycle, and loans written-off annually remain constant over a number of year.
3. As for the bad debt reserve as a whole, the reserve should equal \$10,000 in order to cover the net charge-offs of \$5,000 per year that will be taken over the two-year collection cycle. Where the reserve balance is not equal to the losses inherent in the portfolio, the total bad debt deductions against income will not match the economic loan loss that has occurred. The bad debt reserve under the three year moving average method will never reflect the losses inherent in the loan portfolio as long as the bank in this example has a two year collection cycle. The specific charge-off method obviously does not reflect the loan losses inherent in the portfolio since there is no reserve at all under this method.

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99TH CONGRESS
1ST SESSION

S. 1263

To amend the Internal Revenue Code of 1954 to require conformity between the loan loss reserve accounts maintained by certain financial institutions for tax purposes and for financial statement purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 7 (legislative day, JUNE 3), 1985

Mr. ROTH introduced the following bill, which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to require conformity between the loan loss reserve accounts maintained by certain financial institutions for tax purposes and for financial statement purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 SECTION 1. LOAN LOSS RESERVES OF BANKS.

4 (a) CONFORMITY BETWEEN TAX RESERVE AND FI-
5 NANCIAL STATEMENT RESERVE.—Section 585 of the Inter-
6 nal Revenue Code of 1954 (relating to reserves for losses on
7 loans of banks) is amended by striking out subsection (b) and
8 inserting in lieu thereof the following:

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1 “(b) RESERVE FOR BAD DEBTS.—For purposes of sec-
 2 tion 166(c), subject to the limitations of subsection (c), the
 3 reasonable addition for the taxable year to the reserve for bad
 4 debts of any taxpayer described in subsection (a) shall be the
 5 amount necessary to bring the balance of the tax reserve for
 6 bad debts as of the close of the taxable year to an amount
 7 equal to the amount of the financial statement reserve for bad
 8 debts maintained by the taxpayer as of the close of such tax-
 9 able year.

10 “(c) LIMITATIONS.—

11 “(1) MAXIMUM FINANCIAL STATEMENT RESERVE
 12 RECOGNIZED.—For purposes of subsection (b), the
 13 amount of the addition for any taxable year shall not
 14 exceed the amount necessary to bring the balance of
 15 the tax reserve for bad debts up to 1.5 percent of total
 16 loans of the taxpayer.

17 “(2) MAXIMUM ANNUAL DEDUCTION.—Notwith-
 18 standing paragraph (1), the amount of the deduction al-
 19 lowable for any taxable year under subsection (b) shall
 20 not exceed an amount equal to 0.5 percent of total
 21 loans of the taxpayer as of the close of the taxable
 22 year. The amount of the limitation imposed by the pre-
 23 ceding sentence shall be determined without regard to
 24 net charge-offs. For purposes of this paragraph, the
 25 term ‘net charge-offs’ means, for any taxable year the

1 amount by which the sum of the amounts charged
 2 against the reserve for the taxable year exceeds the
 3 sum of recoveries of bad debts for the taxable year pre-
 4 viously charged to the reserve.

5 “(d) INITIAL ADJUSTMENT OF TAX RESERVE DEFICI-
 6 ENCY SPREAD OVER 6 YEARS.—In the case of a taxpayer
 7 described in subsection (a), if the balance of the tax reserve
 8 for bad debts maintained by the taxpayer as of the close of
 9 the last taxable year beginning before 1985 is less than the
 10 balance of the financial statement reserve for bad debts main-
 11 tained by the taxpayer as of the close of such taxable year,
 12 then the balance of the tax reserve shall be adjusted, as of
 13 the first day of the first taxable year beginning after 1984, to
 14 an amount equal to the balance of the financial statement
 15 reserve for bad debts maintained by the taxpayer. The adjust-
 16 ment shall be taken into account by the taxpayer (as a deduc-
 17 tion) in computing taxable income in equal amounts over a
 18 period of 6 years beginning with 1985.”.

19 (b) CONFORMING AMENDMENTS.—

20 (1) SECTION 57 AMENDMENT.—Paragraph (7) of
 21 section 57(a) of such Code (relating to reserves for
 22 losses on bad debts of financial institutions) is amended
 23 by striking out “585 or”.

24 (2) SECTION 291 AMENDMENT.—Subparagraph
 25 (A) of section 291(e)(1) of such Code (relating to excess

1 reserves for losses on bad debts of financial institutions)

2 is amended by striking out "585 or".

3 SEC. 2. EFFECTIVE DATE.

4 The amendments made by section 1 of this Act shall

5 apply with respect to taxable years beginning after 1984.

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THE INTERNATIONAL MONETARY SYSTEM

A REPORT

by

Nancy Hewitt Katz
Financial Analyst

on

THE INTERNATIONAL MONETARY SYSTEM

1987

The views expressed within this report are those of the author.

Since 1973, international currencies have been allowed to float. During the final years of the Bretton Woods par value system, fixed exchange rates became seen as incompatible with high international mobility of capital and independent domestic policies. Supporters of floating rates believed that exchange market pressure would be reflected in movements in currency prices rather than in domestic reserves (and consequently in the domestic monetary base). In addition to preserving the independence of domestic policy, flexible rates were expected to promote trade by allowing economies to respond quickly to imbalances and changes in the international environment.

The current world imbalances show that the promises of the flexible rates have not been fully realized. Recently, the system has received much scrutiny. Perceived shortcomings of the system include a tendency toward excess exchange rate volatility, large and persistent misalignments, and lack of discipline in the conduct of macroeconomic policy. One report characterized the floating exchange rate system as having degenerated into "an orgy of speculative excess." Such exchange rate behavior is such as costly in terms of resource misallocation and impediments to international trade.

Supporters of the current system point to the contribution of exchange rate flexibility to external payments adjustment, insulation from shocks, and independence of monetary policy. Supporters note that with more rigid exchange rates, international disturbances would be transferred to goods or labor markets, and recall that the Bretton Woods system neither eliminated exchange rate volatility and payments imbalances, nor imposed economic discipline. Once the system placed too great a demand on the domestic economy (in the form of a large U.S. current account deficit), it was abandoned.

Most supporters and critics of the present system agree that the system could be improved by achieving more automaticity in the adjustment and coordination process, that the variability of exchange rates is a cause for concern, and that unsound policies have been one source of volatility and misalignment of key currencies. Consensus appears to be growing that a smoothly functioning international monetary system requires greater coordination of domestic economic policies.

While there are growing calls for reform, there is wide divergence of opinion regarding the optimal monetary system. The criteria for a new system recommended by U.S. Treasury Secretary James Baker include compatibility of nations' domestic policies, convergence of their economic performance, flexibility to respond to unexpected developments, political commitment, and 'automaticity': requiring nations to alter their policies when their economies fall out of line with others'. (For an outline of the major alternatives or reforms that have been proposed, see Appendix A.)

The ongoing negotiations among the Finance Ministers of the major industrial countries represent a recognition that the present system needs to be improved, and signals some movement toward coordination of policies. However, many are skeptical that these countries will have the political will to make and keep international commitments. A recent study of international cooperation efforts by the Institute for International Economics concludes that the large nations are good at crisis management (as shown by the Plaza Agreement), but have failed to build a solid partnership that endures over the long run. Most nations are fiercely protective of their independence, and any progress toward international policy coordination is likely to be slow and sporadic.

There is wide choice of exchange arrangements permitted under the current system by the Articles of Agreement of the International Monetary Fund. The Fund takes the position that the appropriate degree of exchange rate stability differs from country to country and more currencies are pegged to another currency or basket of currencies than are allowed to float freely.

The diversity of exchange arrangements makes it hard to define the "rules of the game." In its role as a promoter of international economic policy coordination, the International Monetary Fund is responsible for exchange rate surveillance according to the rules set forth under the Fund's Articles of Agreement. (See Appendix B for a description of the role of the International Monetary Fund.) However, as one Treasury official noted, the Articles are "like the Bible -- you can find anything you want in them." The world monetary system lacks a 'regime' such as the General Agreement on Tariffs and Trade (GATT), which provides the groundrules and institutional framework that govern the international trading system. The IMF has not had a role in the recent summits, which have convened in an attempt to improve policy coordination and stabilize the international monetary system.

Notwithstanding the absence of firm international monetary rules, it is generally agreed that the levels at which currencies of the Asian Newly Industrializing Countries (NICs) have been held are too high and do not reflect the underlying economic fundamentals. With regard to trade issues, the domestic markets of Korea and Taiwan are very protected. Both policies are difficult to defend in the face of the surpluses these countries are running and the levels of development they have achieved. U.S. policy holds that their levels of development differentiates them from developing countries who can make a case for the need to protect domestic industries through trade barriers and exchange rate manipulation. The U.S. and the other members of the G6 have stated that the NICs must now assume some responsibility for adjusting their trade imbalances and contributing to the overall health of the international system.

There are also domestic factors that boosted the U.S. dollar and contributed to the trade deficit. Many economists agree that the restrictive monetary and expansionary fiscal policies in the 1980s produced a record budget deficit and high real interest rates, and contributed to the rise of the

dollar⁶ and deterioration of the U.S. current account.

Low savings and investment rates have hurt U.S. productivity and competitiveness in world markets, and U.S. business has been criticized for not capitalizing on the lower dollar or on trade opportunities that have opened up in the NICs. It is also argued that the current account deficit will persist as long as the U.S. budget deficit persists. A recent report by the Council of Economic Advisors concludes that:

The massive deterioration of the U.S. trade balance clearly has not occurred primarily because foreign trade practices have become vastly too unfair ... The deterioration ... is too pervasive to be credibly explained by analyses focused on a product-by-product, country-by-country basis. Rather, the bulk of the deterioration must be viewed as a product of general macroeconomic developments in the United States and the rest of the world. (Cited in Hobart Rowen, "Legislation No Solution to Trade Deficit," *The Washington Post*, Feb. 5, 1987.)

Addressing the budget deficit⁸ and other domestic problems to complement the lower dollar must be an integral part of the trade solution.

In the 18 months since the Plaza Agreement, the U.S. trade balance has shown little improvement. In the fourth quarter of 1986, exports rose 13.6 percent -- the second consecutive quarter of double digit increase. However, in January 1987, the trade balance worsened, to \$14.8 billion, with imports running at twice the level of exports.⁹ According to some economists, this is a signal that the trade deficit has not turned around, despite continued administration predictions of a \$30-40 billion decline in the deficit in 1987.

Problems for U.S. exporters remain: a weak world economy and demand, particularly in traditional markets such as Latin America, growing competition from the newly industrializing economies, and the willingness of Japanese producers to cut their profits in order to maintain their market share. As Federal Reserve Board Chairman Paul Volcker observed, the U.S. cannot correct its trade imbalance itself: U.S. trading partners must boost their own economies to adjust world imbalances.¹⁰ This underscores the need for cooperative efforts to address the current international imbalances.

NOTES

¹ Exchange rate misalignment is generally characterized as deviation from the underlying competitive relationships. In practice, it can be calculated in several ways: (1) as departure of the nominal exchange rate from the path implied by purchasing power parity, (2) in terms of the size of the real exchange rate movements, and (3) as the deviation of the real exchange rate from the level that would yield an equilibrium balance of payments.

² The floating rate system does not insulate domestic policies from external factors. In recognition of this, according to observers, the Federal Reserve Board has become increasingly attentive to exchange rates in its conduct of monetary policy. According to Chairman Volcker, the 1984 decision to move to an easier monetary policy was due, in part, to "a desire to curb excessive and ultimately unsustainable strength of the dollar." More recently, the Federal Reserve has been cautious about relaxing monetary policy in the face of a declining dollar.

³ Another element of the discussion involves the question of whether direct exchange rate action should precede adjustment of economic policies, or vice versa. Richard M. Cooper and C. Fred Bergsten support the former route. Cooper argues that initial currency change is preferable to gradual policy action because its impact is felt immediately and market uncertainty is reduced. ("Dealing with the Trade Deficit in a Floating Rate System," 1986.) Bergsten suggests that the objective of the international system should be to promote compatible and sustainable domestic policies. ("The Case for Target Zones," 1986.)

Opponents of exchange rate manipulation fear that direct exchange rate action can result in loss of control over rates and may actually increase market uncertainty. They also question whether it is possible to determine, much less agree upon, equilibrium in exchange rates or underlying competitive positions. According to one economist, it is naive to believe that an external system can impose discipline or "protect us from bad policies," and he suggests that manipulation of exchange rates will confuse matters and reduce the information essential to policy making. (Jacob Frenkel, "Seeking a Solution through Policy Coordination," 1986.)

⁴ According to a recent IMF report, empirical evidence suggests the smaller, more open economies experience greater domestic price disturbance and less relative price advantages than do larger, less open economies. Excessive exchange rate variability is a particular problem for developing economies that rely on foreign investment and export earnings to finance their development. (Andrew Crockett and Morris Goldstein, *Strengthening the International Monetary System*, 1987.) Other studies suggest that free floating is not feasible in countries with thin or undeveloped financial markets (such as Korea and Taiwan), because private speculation becomes very destabilizing. (William H. Branson, "Economic Structure and Policy for External Balance.")

⁵ The Asian NICs, also referred to as the "Four Tigers," are South Korea, Taiwan, Hong Kong, and Singapore.

⁶ Other factors cited in the dollar's rise include confidence in U.S. economic performance, lower U.S. inflation, and general "safe haven" considerations. According to economist Otto Eminger, the strength on the dollar is "the most over-explained -- and maybe least understood -- economic event of our time." ("The Dollar's Borrowed Strength," Group of 30 Occasional Paper No. 19, 1985.)

⁷ Korea, Taiwan, and Hong Kong have high savings levels and a competitive advantage over the U.S. because they have equaled or surpassed the productivity levels in many American manufacturing industries while maintaining lower unit costs of production. For the first time in six years, U.S. non-financial productivity did not increase in 1986, and manufacturing productivity actually declined in the final quarter. According to Federal Reserve Board Chairman Volcker, to export enough to wipe of the trade deficit, the U.S. will have to increase its manufacturing output by 30 percent over the next five years, but "we aren't investing in industry at a rate to support that growth."

⁸ The U.S. investment-savings imbalance exists because while investment levels are normal for this stage of an economic cycle, the savings level has been abnormally low. The national accounts identity tells us that net foreign investment (approximately the balance on goods and services) equals national savings minus domestic investment. The high level of U.S. government dissavings (in the form of the federal deficit) will keep net foreign investment (and the trade balance) in deficit or force domestic investment to decline. This is why many economists argue for a reduction in the deficit (which has been absorbing 5-6 percent of GNP) and a closing of the investment-savings imbalance as necessary conditions for addressing the trade imbalance.

⁹ The January trade figures reflect both an increase in imports (due to increased imports of oil and manufactured goods) and decrease in exports (on a slump of agricultural exports). Exports declined 11.5 percent from the December level, to \$16.4 billion, the lowest level since 1983. The bilateral trade deficits with Korea, Taiwan, and Japan each rose from the December level, 75 percent, 50 percent, and 35 percent, respectively. (The December trade deficits, it should be noted, had shown a marked decline from the previous month's level.)

¹⁰ Since mid-1986, Chairman Volcker has consistently argued that foreign demand must grow in order to undo the current international disequilibrium. According to Chairman Volcker, "stronger domestically generated growth in the United States will not reduce the international imbalances. Taken alone, it would aggravate our trade deficit further." Volcker also urged Congress not to try to speed the process of lowering the trade deficit by "resorting to broadbrush protectionism ... world trade and economic activity would be depressed altogether." (Testimony before the Joint Economic Committee, Feb. 23, 1987.)

U.S. COMMERCIAL AND EXCHANGE POLICY TOWARD THE ASIAN NICs

The record U.S. trade deficit (\$170 billion in 1986) has been a growing source of concern both here and abroad. American exports have been so battered that they account for the smallest share of the nation's output since 1977. Economists estimate that exports will have to grow twice as fast as imports merely to keep the deficit from getting any larger.

A major source of the deficit is seen as the high value of the U.S. dollar, which appreciated sharply between 1980-85. Some experts estimate that at its peak, the dollar was overvalued by as much as 40-50 percent. (According to the real exchange rate model of the U.S. Trade Representative, the recent dollar decline has undone one-third to one-half of this appreciation.)

In September 1985, prompted by the growing trade imbalance, the U.S. held a summit meeting with the other G5 nations (Japan, West Germany, France, and the U.K.). The 'Plaza Agreement' represented the end of the Reagan administration's hands-off foreign exchange policy and the start of an on-going multilateral process to address the trade imbalance through exchange rate realignment and economic cooperation. It also represented official acknowledgement of the trade-exchange rate relationship. Spearheaded by Treasury Secretary James Baker, the U.S. strategy has been to force other countries to grow and to open their markets, in an attempt to contain the growing protectionist pressures in Congress. Since the agreement was concluded, the dollar has fallen over 30 percent against a trade-weighted average of G10 currencies.

However, 40 percent of U.S. trade is with countries whose currencies have not appreciated significantly against the dollar. Notable among these are the newly industrializing countries such as South Korea and Taiwan, which ran large bilateral trade surpluses with the U.S. in 1986. Both countries maintain very restrictive trade regimes and peg their currencies to the dollar. (Hong Kong and Singapore, which also run trade surpluses with the U.S., have relatively open domestic markets.)

In early 1985, the U.S. government began to put pressure on Korea regarding that country's severe trade barriers and infringement of U.S. patents. This effort was overtaken by two 301 trade cases, involving insurance and intellectual property. These have been settled and are in the implementation phase under the coordination of the U.S. Trade Representative.

In mid-1986, the Treasury Department initiated bilateral exchange rate talks with Korea and Taiwan, an extension of efforts begun the previous year to bring down the value of the dollar. The talks were considered largely symbolic, as an appreciation in these currencies is not expected to produce

more than a small decline in the overall U.S. trade deficit. However, they are seen as critical to achieving a "level playing field" in international trade; when used to gain an unfair trade advantage, currency manipulation can be considered a form of protectionism.

The focus of these talks has been Taiwan, because its currency appears to be so far out of line with the economic fundamentals. There is also growing U.S. frustration over the slow pace of trade reform. The U.S. approach is two-pronged: to force open Taiwan's markets and loosen the link between New Taiwan dollar (NTD) and the U.S. dollar. After the U.S. began a dialogue with Taiwan, the NTD began to rise and, prompted by the threat of Section 301 cases, Taiwan initiated several measures to open its markets.

In a speech to the Asia Society in November 1986, Treasury Secretary Baker made a relatively mild statement on exchange rates, the message being that the Asian NICs have benefitted from an open international system and "are ready to be brought into the world trading system as full-fledged participants." Baker noted that the U.S. trade deficits with these countries are unsustainable, and restated the U.S. position that foreign exchange rates should reflect the underlying economic fundamentals.

In December, Treasury Deputy Assistant Secretary Charles Dallara made a visit to Taiwan to continue the discussion on the exchange rate situation. Addressing the Joint Conference of the ROC-USA Economic Councils in Taipei, Dallara encouraged Taiwan to undertake measures to liberalize its financial system, stimulate domestic demand and investment, and reduce its excess dependence on the U.S. market. Both Baker and Dallara emphasized that the administration is prepared to use its trade laws, if necessary, to open foreign markets.

In Congressional testimony in February 1987, Secretary Baker said he will continue to talk to Taiwan and Korea, and possibly the other NICs, in an effort to get their currencies to appreciate. Acknowledging that "more than talk" may be necessary, Baker cautioned that the "behind the scenes" maneuvering should not be publicized. (Senate Finance Committee, Feb. 19, 1987.) Federal Reserve Board Chairman Paul Volcker has also singled out Taiwan and Korea as having "clear responsibility for contributing to a better world balance." (Testimony before the Senate Committee on Banking, Feb. 19, 1987.)

The issue of the won and the NTD was addressed in the most recent meeting of the Finance Ministers from the U.S. and its major trading partners. Recognizing that the U.S. dollar decline had not affected these currencies, the six industrial nations called on the NICs to do more to adjust their currencies and to reduce their trade barriers. This was the first multilateral approach toward the NICs. It was also the first tangible sign that U.S. government feels further dollar declines against the major currencies may be counterproductive at this time. (See Appendix C for a chronology of the coordination efforts of the major industrialized countries.)

Last year, the administration came under heavy pressure from Congress to take a hard line with Korea, Taiwan, and Hong Kong. In mid-1986, these countries each signed restrictive bilateral trade pacts, effectively cutting their yearly growth of textile and apparel exports to the U.S. to less than one percent from the current level of 5 to 10 percent for the period 1986-89. In a review of the General System of Preferences, the USTR substantially reduced the value of trade benefits granted to Korea and Taiwan. (For bargaining purposes, the U.S. still has the threat of eliminating the benefits completely.) Singapore, which maintains an open trade regime, received an increase in GSP benefits.

In January 1987, the U.S. completed a series of meetings on trade issues with Korea and presented them with the U.S. market access agenda for 1987. The focus will be on telecommunications, agriculture and shipping. A trade round including the MICs is scheduled for this spring. (In the face of the restrictive bilateral textile pacts, the MICs are said to be wary of the upcoming talks.)

The dialogue on exchange rates with Taiwan and Korea that began in 1986 continues. The negotiations are conducted very quietly at the highest levels of the Treasury Department. The State Department and the USTR do not consider themselves to be a part of these discussions and, for the most part, have not been consulted.¹⁰ The USTR has approached Taiwan on the exchange rate issue, to the effect that, given the country's surpluses, Taipei should adjust the value of the NTD. However, as a rule, exchange rates are not part of the trade agenda. It is felt by officials within and outside Treasury that exchange rate concerns are getting a "very appropriate level of attention ... there is no question that [these countries] understand our position."

In the area of exchange rates, Singapore and Hong Kong are not U.S. cabinet-level concerns at this time. In August 1986, Treasury Secretary Baker met with Singapore's Finance Minister to discuss the issue of exchange rates. The relatively mild message was that countries should not use exchange rates in a predatory fashion.

There has been some movement toward trade and financial liberalization in Korea and Taiwan. However, the consensus among U.S. officials with whom I met is that these have not been significant and that fundamental change is not imminent.¹¹ The administration is seen as realistic in its expectations for progress in these negotiations. There is some sense that the U.S. has greater chance of winning concessions from Taiwan than from Korea, which is a large debtor nation. Korea is considered a "showcase capitalist economy" whose performance (and political stability) the U.S. is unwilling to jeopardize.

In the current negotiations, trade and exchange rates are treated as separate, if related, issues. It is U.S. policy not to trade off one for the other; without market access, adjustment in relative exchange rates will have little impact on the U.S. trade balance. The USTR takes the lead in trade

negotiations and the Treasury Department has virtually exclusive responsibility for international monetary issues.

While U.S. negotiators use the threat of protectionist legislation to achieve concessions from trade partners, those with whom I met agreed that legislatively mandated protectionism and foreign exchange market intervention¹² would not serve to open foreign markets, and would add to the fragmentation of U.S. trade and exchange rate policymaking.

In June 1987, the summit nations will meet in Venice to unveil reports mandated at the 1986 Tokyo summit. If successful, the reports will reflect a G7 agreement on medium term objectives for international monetary coordination and will put in place a system of "objective indicators" that will act as a "sign post" (determining when divergence among economies calls for policy action) in the short term. The indicators are expected to be kept confidential.

NOTES

¹ The issue of exchange rate equilibrium has been the source of debate. Some question the relevance of "over-" or "under-valuation" in such a system. John Williamson of the Institute for International Economics has developed the concept of "fundamental equilibrium." In this model, the equilibrium rate is defined as the rate that maintains basic balance in the medium term. (See John Williamson, "The Management of the Dollar," 1986.)

² The effect of changes in exchange rates differs among economies. For example, a recent study concludes that in the U.S. economy, exchange rate movement has its main effect on trade by changing relative prices; this makes it an effective instrument for external adjustment. However, in Europe, changes in the exchange rate impact on domestic prices, making it a poor instrument for such. Moreover, demand policies in economies with real wage stickiness (as in Europe and Japan) influence price level, rather than output. (William H. Branson, "Economic Policy for External Balance.") This suggests that current G5 initiatives to change the currency values and stimulate demand in the economies of the U.S. trade partners may not have their intended effects.

³ This calculation is based on the Federal Reserve Board index, which used the multilateral trade weights of the G10 currencies, according to their share of world trade in 1972-76. There are several competing indexes. The International Monetary Fund uses an index based on its Multilateral Exchange Rate Model (MERM), using 14 industrial country currencies weighted by their trade relations and elasticities. Recently, the Federal Reserve Bank of Dallas developed an index (called X-131) measuring the dollar against all U.S. trading partners, weighted by their shares of total bilateral trade in 1986. According to X-131, there has been a much smaller decline in the value of the U.S. dollar

(roughly 6 percent since the peak in February 1985). One recommendation of recently proposed trade legislation is the development of a single exchange rate measure that accurately reflects the current trade environment.

⁴ In 1986, the combined bilateral trade surpluses of the Asian NICs with the U.S. totaled \$26 billion (or 20 percent of the U.S. trade deficit). This is greater than the bilateral surplus of the entire European Community.

⁵ Under Section 301 of the 1974 Trade and Tariff Act, the U.S. can impose sanctions against the exports of another country to the value it deems it has suffered from that country's unfair trade practices.

⁶ According to a State Department official, "we've reached some agreement: the key now is implementation." The implementation of bilateral agreements is viewed by U.S. negotiators as a separate source of problems and delay in achieving trade concessions.

⁷ Before the talks were launched, a Wall Street Journal article broke the story and created a furor in the diplomatic community. It resulted^a a particular problem for Seoul, where the government was already under domestic pressure for having given in to the U.S. on the Section 301 cases. According to State Department officials, at a time when Korea may have intended to appreciate its currency (the won), it was put in a defensive posture. (Korean officials held the won steady until year-end, when it was allowed to appreciate quietly by about 3 percent.)

⁸ The inclusion of a statement regarding the NICs in the G6 (the G5 nations and Canada) communique was done at the initiative of the U.S. The goal was to "get others [summit nations] on board and increase the pressure [on the NICs] somewhat," as well as to remind Congress that the administration is tackling these problems. Japan was initially concerned that traditional hostilities with Asian countries would undermine such efforts. The European nations, which recently have been affected by a surge in Asian imports, were apparently less reluctant to acknowledge the existence of a problem.

⁹ There has been some criticism of U.S. trade policy and negotiating efforts. American businessmen and diplomats in Korea have complained that the U.S. approach is disorganized. (At one point, the U.S. had eight separate delegations in the country.) There is also concern that American trade interests are suffering from the lack of a coherent trade policy, coupled with an overworked, understaffed USTR faced with growing trade disputes.

¹⁰ Since 1979, the U.S. has not had official diplomatic relations with Taiwan. At the State Department, the Taiwan Coordinating Unit acts in place of a country desk. The Unit has been consulted on the manner of the negotiations, which must be conducted according to the Taiwan Relations Act. The Act governs all U.S.-Taiwan contacts.

¹¹ The restrictive trade and financial systems in Taiwan and Korea have created

structural problems for the economies and may threaten their future development, and observers feel that many of the recommended reforms would be beneficial to these countries. (See the country briefs that follow.)

¹² Some argue that foreign exchange intervention is a tricky prospect in 24-hour global markets, in which private market participants have far greater resources than central banks. The average daily volume of currency transactions has reached the level of \$150-200 billion, whereas the Treasury Department's exchange stabilization fund, which is used for intervention operations, holds about \$10 billion. (It should be noted that a Group of 10 study concludes that exchange rates are not influenced by the quantities put in the market, but by the credibility of a country's announced actions.)

Unless sterilized, foreign exchange intervention affects the monetary base of the intervening country and impacts the conduct of monetary policy. The empirical evidence is inconclusive, however there is some question about the effectiveness of intervention when it is sterilized to offset this. (The U.S. undertakes sterilized intervention when it intervenes.)

CONCLUSION

There are several messages that can be drawn from this look at the international monetary system, in general, and U.S. policy toward the Asian NICs, specifically. Among these are:

- o The magnitude of current global imbalances points to the need for new, global solutions. Traditional domestic measures have proven to be ineffective;
- o Surplus nations share responsibility with deficit nations for returning the system to a stable growth path;
- o Nations that have achieved high levels of development and domestic wealth have obligations to enter the international system as equal partners in preserving its welfare;
- o Comprehensive reform of the international system is unlikely at this time. However, there is wide consensus that greater cooperation and coordination of domestic economic policies are feasible and desirable;
- o Changes in the exchange rate will have only a limited and short term effect on the trade balance without a change in the underlying economic fundamentals;
- o The real achievement of the Plaza Agreement was to focus attention on these macroeconomic fundamentals. The U.S. (as well as its trading partners) must continue to address the domestic problems that have contributed to global imbalances;
- o U.S. policymakers and exporters must be more vigilant in exploiting new sources of competitive advantage and market opportunity;
- o Bilateral and multilateral approaches toward the Asian NICs on trade and exchange rate issues are continuing;
- o There is no evidence of fundamental trade and exchange rate reforms in either Korea or Taiwan;
- o The structural reforms recommended for Korea and (particularly) Taiwan, would benefit those countries' future development efforts;
- o The entrenched nature of the trading and exchange regimes in the NICs means that and the mentality of the policymakers and local populations must change before fundamental change can be seen. As a result, reforms will come very slowly and intermittently;
- o There has been some exchange rate appreciation in Korea and, to a

greater extent, in Taiwan. This may continue⁴ their economic growth continues to be strong;

- o Market access is a policy problem separate and distinct from exchange rate management;
- o Political tensions and the high level of foreign debt in Korea mean that reforms are less likely to be undertaken than in Taiwan;
- o Hong Kong and Singapore are not targets⁵ U.S. cabinet-level initiatives on exchange rates at this time;
- o Changes in income and domestic consumption patterns in the NICs would create a potentially rich market for American exports;
- o The growing need for foreign investment, capital, and technology within the Asian NICs, coupled with these countries' strong drives to reduce their dependence on Japan, represents a potential opportunity for U.S. businesses;
- o Access to the market of the People's Republic of China through the Hong Kong "gateway" should not be neglected; and
- o The appreciation of the non-dollar currencies means that these markets will become relatively more attractive to NIC exporters and reduce some pressure on U.S. markets.

SOUTH KOREA

ECONOMIC BACKGROUND

The Korean economy is booming. Following a slowdown (by Korean standards) in 1985, the economy recovered in 1986, with real GNP growth estimated at over 12 percent.

Korea's 1986 economic performance was largely export-driven. Exports rose almost 30 percent in 1986 and the country achieved an overall trade surplus totalling \$4.8 billion. Korea also achieved its first significant current account surplus (the country had a small surplus in 1977). Korea's primary markets (notably the U.S.) recovered in 1985-86, and the relatively strong yen enhanced Korea's export competitiveness vis-a-vis Japan. (More so than Taiwan, Korea competes directly with Japan, particularly in the areas of electronics, automobiles, and manufactures.) According to one local manager, "No one ever dreamed of this kind of chance [to compete against Japan]." The country hopes its trade surplus means the economy has reached a turning point in its export-led effort toward industrialization.

Much of the improvement has been attributed to lower world interest rates, falling oil prices (Korea imports all of its oil, some 200 million barrels annually), and the sharp appreciation of the Japanese yen. However, Korea's low wage rates,¹ productive labor force, high savings level, and strong investment in strategic industries continue to contribute to the country's economic success.

Korea's sizable debt, estimated at \$45 billion at the end of 1986, makes it the fourth largest debtor in the developing world. Reserves are relatively small, constituting only a one month cover. The external debt is a potentially volatile political issue in Korea: some feel the economy has become too vulnerable to its foreign creditors and that foreign capital will dry up and jeopardize Korea's development efforts.

The Korean government was able to defuse the issue last year on the back of the country's strong economic performance. Last year's current account surplus enabled Seoul to retire over \$2 billion of its sizable foreign debt. However, the debt remains an area of deep concern, and Korea's commitment to continue running surpluses and reducing its debt continues firm.

The appreciation of the yen has taken more time to work itself through the domestic economy. Japan has not been a successful market for Korean exporters. However, the rising yen has encouraged Japanese companies to move production facilities to Korea in an attempt to hold onto their markets and has helped Korean exporters in third markets, particularly the U.S. and Europe.

Korea has been shifting into higher value added production and exports.

in an attempt to become a world class industrial power. Current development efforts focus on high-tech production and Korea is spending heavily on developing acceptance of Korean brand names.

To attract foreign technology and expertise, Korea has opened new sectors of its economy to foreign direct investment² and developed incentives to attract component joint ventures, particularly in the electronics and auto industries. Almost \$1 billion in foreign direct investment was authorized in 1984-85, as compared with less than \$2 billion total for the previous twenty years. The government has said it wants to raise annual investment inflows to \$1 billion by 1988. Many U.S.-based industries have shown an interest in participating in joint U.S.-Korean ventures, but face strong resistance from entrenched Korean interests. To date, the liberalization effort has been limited to areas in which Korean companies have a competitive advantage.

The focus on high-tech exports has meant something of a shift away from textiles. While 1986 was a good year for Korean textile exports, the country faces growing competition from other Asian textile exporters as well as rising protectionist threats. (Textile and clothing still account for 25 percent of Korea's total merchandise exports.) In 1986, Seoul signed a bilateral agreement with the U.S. limiting the growth of its textile exports to 0.5 percent per year through 1989. Some have called this agreement excessively restrictive and potentially costly to U.S. consumers (Taiwan and Hong Kong signed similar agreements). However, one U.S. official observed that the agreement preserves Korea's already sizable market share and shelters Korean exports from its increasingly successful foreign competitors.

The U.S. is Korea's most important market. (Korea is the America's seventh largest trading partner.) Despite concern that the economy is overdependent on the U.S. market (in 1986, 40 percent of Korea's exports went to the U.S.-- a "perilous concentration"), and despite a recent reduction (by 24 percent) of U.S. GSP benefits, there is little indication that this will change. The U.S. is a natural market for Korean exports, particularly as they increase in sophistication and price. Alternative markets, such as the EC and Latin America, are much more protected and are currently experiencing weak internal demand. Korea is angered by American protectionist threats and considers itself a strong U.S. ally³ that should continue to receive preferential treatment.

Korea is also highly dependent on Japan, in this case for exports of machinery and key parts. It is estimated that one-third of the inputs of Korean exports originated in Japan.⁴ Any increase in Korean exports means increased imports from Japan. In this regard, the appreciation of the yen has hurt Korea, whose trade deficit with Japan nearly doubled in 1986, to \$5.1 billion.

Reducing the economy's dependence on Japan has been given "the highest priority" by the government and the current Five Year Economic Plan,⁵ with emphasis on promoting domestic high-tech industries and encouraging the development of parts manufacturers. The government hopes to switch 20 percent

of the components it now obtains from Japan to suppliers in the U.S. and Europe, where goods are now relatively less expensive. (The Korean government has identified 600 industrial sectors for which they had a great dependence on Japan and for which they were seeking U.S. or other substitutes.) Korea will try to produce another 20 percent domestically, and has undertaken an import substitution program involving the promotion of small and mid-sized companies, particularly in the areas of computers and telecommunications.

The import substitution effort poses potential problems for the U.S. Likely new government policies, such as the adoption of infant industry status, may hurt the U.S. in areas in which it has exported successfully.

Korea faces structural problems, the result of an overemphasis on heavy industry and a large debt buildup. The highly concentrated economy is dominated by *chaebols*, large conglomerates that are the product of Korea's early development efforts. The government provided access to low cost credit and encouraged ambitious programs in heavy industry. Many of the ventures of these highly leveraged conglomerates failed, leaving local banks saddled with large non-performing loans. (The government has now restricted the flow of funds.) However, as a result of this development strategy, Korea is emerging as an industrial power and a leader in such major industries as steel, autos, and semiconductors.

Korea maintains one of the world's largest military establishments. 1983 military expenditures totaled 6 percent of GNP and constituted one-third of the national budget. This distinguishes the country from Japan and has been cited as a potential source of weakness for the economy.

The U.S. government complains frequently to Korea, which has gained a significant share of the U.S. markets with its high quality and low cost exports, about its protected markets. Korea has a much tighter import regime than does Taiwan. Protection is dominated by quantity restrictions, usually in the form of restrictive licensing, although tariffs and taxes also persist. Barriers exist most frequently against non-manufactures and crude materials. Korea is also accused of being a major counterfeiter of U.S. consumer goods and has recently moved to restrict nonessential imports in offset its traditional current account deficit.

Korea has run a bilateral trade surplus with the U.S. for the last five years. In 1986, the surplus with the U.S. rose 60 percent, to \$7.8 billion. (This exceeds the country's overall surplus.) The country's 1986 export boom was particularly strong in automobiles and electronics.

Since early 1985, there has been a series of negotiations on the bilateral trade situation and several developments that U.S. trade officials consider to be evidence of progress. Korea is aware of, and alarmed by, the rising protectionist sentiment in the U.S. Seoul is fighting its image as a single-minded exporter, and insists it is proceeding steadily with its announced schedule of liberalization measures that will provide greater access

to Korean markets.⁸ (Seoul has been wary of publicizing its 1986 economic success for fear of triggering retaliation or protectionism.) Observers also express the hope that Korea's efforts to reduce its dependence on inputs from Japan (where imports are now relatively more expensive) and growing need for foreign investment and technology will encourage further economic liberalization.

However, the bottom line is that the Korean economy is dependent on trade. Exports have been the main engine of growth since the early 1960s; in 1986, exports contributed to 40 percent of GNP. Economic incentives for liberalization are countered by political impediments and opposition from strong economic interests. The country's bureaucrats are slow to implement reforms initiated by policy makers. (Local policy makers are well aware of this, and priority measures can be instituted by Presidential Decree thereby bypassing much of the bureaucratic maze. Similarly, Seoul may choose to use the bureaucracy to stall the implementation of measures that unpopular.)

The size of the country's foreign debt -- \$9 billion of which is owed to U.S. banks -- also drives Korea's compulsion for surpluses. (Korea aims to reduce its debt to \$33 billion by 1991.) Korea considers itself a poor, developing nation that will be hurt by too rapid market opening measures. Korea's GNP is one-seventh the level in the U.S. and per capita GNP, which, at around \$2,300 per year, is well below that of Taiwan and Japan. Korean officials are tough negotiators and the country proceeds with reforms very cautiously. Often, trade and financial reforms in one area are cancelled out by new impediments¹⁰ in others, and many industries remain heavily protected. There are also many informal barriers that are hard to identify and eliminate. It is difficult to determine whether there has been overall liberalization, but most U.S. officials claim the gains have been small. According to one official, Korea's reforms look better on paper than in practice.

Concern about U.S. retaliation may keep the surpluses from growing, but is not likely to reverse them. There is strong domestic opposition to free market competition, particularly from the country's powerful *chaebols*. The Korean people are also angered by U.S. demands for open markets coming on the heels of U.S. actions to close its markets to Korean exports. Economic issues are so sensitive domestically that the government makes no public announcement of the actions it takes in response to U.S. demands because, "We can't afford to look like we are kneeling to U.S. pressure."

FINANCIAL AND CURRENCY MARKETS

Until 1980, the Korean won was pegged directly to the U.S. dollar. Since 1980, the won has been pegged to a multicurrency basket (consisting of a trade-weighted basket and the SDR basket). The details are confidential, but the basket is weighted heavily toward the U.S. dollar.¹¹ The won has appreciated

only slightly against the U.S. currency in the 18 months since the Plaza Agreement.

The Bank of Korea establishes daily the exchange rate of the won in terms of the U.S. dollar. Rates for other currencies are posted daily by the foreign exchange banks. There is a policy component to the daily fixing of the won. Prior to 1986, Seoul's policy was to depreciate the won against the U.S. dollar by about 6 percent a year to boost exports. This meant that as the dollar appreciated, won also rose against the major non-dollar currencies. The policy had the effect of hurting Korea's overall export performance and contributing to a growing reliance on U.S. markets.¹³ The share of Korean exports to the U.S. rose to 40 percent, from less than 30 percent in the late 1970s.

The economy was helped after 1985 as the won tracked the dollar down. Until mid-1986, Seoul continued to depreciate its currency against the dollar (by about 7 percent annually). By early 1986, the won had declined 50 percent against the yen and the DM. This played a large role in Korea's 1986 export surge.

In late 1986, in response to pressure from the U.S., the Korean government announced that it would no longer adjust down the won against the dollar, but ruled out the possibility of a revaluation and reaffirmed its commitment to maintain the present currency basket system. The won rose 3 percent at the end of 1986, and U.S. officials estimate that it may be allowed rise another 5-8 percent in 1987 if the economy remains strong. This is not seen by U.S. officials as an adequate response, given Korea's growing trade surplus with the U.S. (Describing the exchange rate talks with Korea, one Treasury official said, "We have been telling them we have to go to Congress with better numbers than [a 3-4 percent appreciation of the won] if we want to prevent protectionist legislation ... that's laughable. We can't show they've been cooperating with numbers like that. We raise the issue with them every chance we get ... but they are very wary and we can't publicize the issues or we won't get their cooperation. They won't do anything if it's public.")

Korea came under multilateral pressure to adjust its currency following the February meeting of the Finance Ministers of the industrial countries. Korea has tried to distinguish itself from Taiwan, citing the country's heavy debt burden (which at \$45 billion is equal to half the country's GDP) and the resulting need to generate trade surpluses. Shortly after the summit, Korea's Deputy Prime Minister met with U.S. Treasury Secretary Baker to plead Korea's case, but the results of the meeting were not released.

The exchange rate is a sensitive political issue in Seoul. Korea can't be seen as giving into outside pressure and, with elections and Olympics scheduled for 1988, the government does not want to do anything to fuel more unrest. U.S. officials have suggested to Korean policy makers that by letting the won appreciate, Korea would encourage additional U.S. imports and thereby meet another of its major economic goals: reducing its \$6 billion trade

deficit with Japan. Nevertheless, because of the critical importance of exports, the Bank of Korea remains committed to ensuring exchange rate competitiveness. The effect that an appreciation of the won would have on the U.S.-Korean bilateral trade balance is not clear. Korea's markets remain very protected, and much of the trade issue is a problem of access. Moreover, it is likely that Korean exports compete with Japanese, not American, goods, and will be replaced quickly.

Korean financial markets are heavily regulated. The government controls the banking system, but has promised some liberalization. There has been some interest rate deregulation and opening to foreign portfolio investment; however, restrictions on foreign banks remain tight.

POLITICAL SCENARIO

Korea's political situation has always been a negative counterweight to the country's stunning economic performance. Power in the Republic of Korea is centralized in a strong executive. The regime of President Chun Doo Hwan, who came to power in a military coup in 1980, is considered fairly repressive and regarded as illegitimate by many in the country. Political opposition is unified and generates growing popular support, and political unrest has been rising. To counter the continuing threat of the aggressive Communist regime in North Korea, security remains a priority, and security forces play a role internally as well as externally (Korea's security forces are charged with suppressing domestic dissent and political opposition.) Defense spending constitutes a high proportion of GNP.

The government, while unpopular, is neither incompetent nor corrupt and Korea's economic technocrats have provided strong leadership for growth and development. The economy has consistently achieved or surpassed its ambitious targets. Today, U.S. assessment of the political situation is that the country's policymakers are moving away from direct government guidance of the economy toward greater reliance on market forces, to increase efficiency domestically and discourage protectionism elsewhere. However, there is no evidence that the government will abandon entirely the strong leadership that many feel is responsible for transforming Korea into a rising industrial power.

Korea will experience its first bloodless political transition, as President Chun has committed to step down when his term ends in 1988. Concerned that Chun will attempt to preserve the military's political dominance, U.S. Secretary of State George Shultz has visited the country twice in the past twelve months to urge an early and orderly transition from military to elective rule.

NOTES

¹ The Korean government urges private sector employers to follow its lead in keeping wages at or below productivity gains to keep its exports price competitive.

² The Foreign Capital Inducement Act (FCIA) was adopted to encourage investment inflows by easing approval procedures and lifting restrictions on remittances and reinvestment. Under the new act, the "negative list system," introduced in 1984 to increase the number of industries open to foreign investment, has been expanded. The proportion of industries open to foreign investment has increased to 76 percent from 66 percent, and the government plans to raise the ratio to 79 percent in 1987 and 90 percent by 1988. Manufacturing industries are to be almost fully open (95 percent) for foreign investment in early 1987. Under FCIA, foreign investors receive financial and tax incentives. Technology intensive industries (particularly machinery, electronics, chemical, and defense) receive special tax incentives. The act authorizes duty-free import of capital goods (except in certain industries, particularly service industries). In addition, modest steps have been taken to liberalize the financial sector and provide more autonomy to commercial banks.

³ Treasury Secretary Baker echoed this sentiment when he noted that Korea "is at the front of [U.S.] national security interests." (Testimony before the Senate Finance Committee, February 19, 1987.)

⁴ This puts an interesting twist on the U.S.-Korea bilateral trade situation. As one U.S. trade official noted, one-third of the U.S. trade deficit with Korea could be considered a deficit with Japan.

⁵ The country's sixth Five Year Plan, which covers 1987-91, calls for balancing the country's trade with Japan by the end of the Plan. Korea, whose development has occurred on the back of Japanese technology, is not expected to achieve this. Other stated objectives of the Plan include: continued high economic growth, improvement of the balance of payments and reduction of the external debt, and adjustment of the industrial structure and development of domestic technology through market liberalization, particularly liberalization of the banking industry and foreign capital transactions.

⁶ Korea's export drive began in 1962, when the government selected promising entrepreneurs and encouraged their growth into large conglomerates. The largest groups were encouraged to set up trading companies patterned after the Japanese model. Technocrats promoted the development of an export-oriented economy through tax, credit, and other incentives, control of imports, and foreign investment.

⁷ In 1986, as a result of a Section 301 trade action seeking protection of intellectual property rights and participation in the insurance industry, U.S. life insurance firms gained access to the Korean market and Korea enacted legislation protecting intellectual property (hitherto an impediment to attracting foreign investment). The intellectual property laws are scheduled

to go into effect in mid-1987 and cover patents, computer software, motion pictures, and copyrights. Korea has also reduced the number of categories for which importers need a license.

⁸ In January 1987, Seoul announced that it will increase imports of U.S. goods in an attempt to hold down the growing trade surplus. Computer imports will be decontrolled in mid-1987. Tariff rates, which now average 22 percent (according to Korean estimates), are scheduled to decline to 16 percent by 1988 (although U.S. exporters complain of tariff rates as high as 40-100 percent on manufactured imports). Formal restrictions on many import items have been eliminated or reduced. Imports of over 300 items have been liberalized, and commodities are scheduled to be removed from the restricted list (160 items in 1987 and 141 items in 1988). In addition, the government has sponsored buying missions to the U.S. in an attempt to reduce the bilateral trade imbalance, but these have been *ad hoc* and not particularly successful.

⁹ In 1986, per capita GNP in Taiwan and Japan was \$3,500 and \$17,000, respectively.

¹⁰ Korea's system of economic regulation is extremely complex. One U.S. official observed that new trade barriers or impediments can "pop up almost overnight" to offset decontrols in other areas.

¹¹ According to one source, the dollar weighting in the basket is 48 percent, compared with 20 percent for the yen and 17 percent for the DM.

¹² The process by which the won is pegged remains something of a mystery. According to one Treasury official, the Korean government has enough exchange controls that "it simply has to announce the rate and it sticks." There is no evidence that Korea has intervened in foreign exchange markets to maintain the pegged level, leading some to speculate that an unpegging of the currency would have little effect on its value. However, the won is an internationally insignificant currency, and, with the country's tight exchange controls (restrictions on current and capital transactions), easily manipulated.

¹³ The best explanation for this policy is that Korea's overriding concern about U.S. market share made it oblivious to potential problems in other markets. (Korea's policymaking process is very closed and not always understood by U.S. observers.)

TAIWAN

ECONOMIC BACKGROUND

Like South Korea, Taiwan had a very good year last year, rebounding from the relatively weak (for Taiwan) 5.3 percent GNP growth in 1985. Exports, which account for 50 percent of GNP, jumped 25 percent to lead the recovery. Taiwan enjoys large surpluses in trade, current, and balance of payments accounts. The country's foreign exchange reserves total an estimated \$48 billion. Industrial capacity utilization exceeds 80 percent; unemployment hovers around three percent; and the budget is balanced. Nevertheless, despite the country's export success, the economy is faced with severe structural problems that may threaten its future prosperity.

Taiwan was transformed into an export-processing zone under Chiang Kai-shek and his son, Chiang Ching-kuo. Last year, Taiwan's exports approached \$40 billion, and the overall trade surplus exceeded \$15 billion. Taiwan's wages and currency are kept low to keep its exports competitive. In addition, the country restricts imports. Tariffs on the capital goods and raw materials the economy needs, such as oil and steel, are low, but duties on consumer products have averaged 40-50 percent. A stiff commodity tax is added to luxury goods.

Taiwan's economy, which is characterized by small and mid-sized companies, is more decentralized than is Korea's, and the government plays a less active role in the country's development. According to Taiwanese officials, this makes the economy much more vulnerable to external trade developments. (Taiwan's more decentralized economy, counters one U.S. trade official, also makes it more flexible in adapting to economic changes.)

Taiwan's growth has been based on a relatively small number of light industries. Electronics and textiles are Taiwan's most important export products. Growing protectionism against traditional Taiwanese exports and competition from lower wage developing countries were largely responsible for the 1985 economic slowdown. However, because it has not been able to take advantage of large scale production or concentration of capital, Taiwan lags Korea in industrial development. The government is trying to encourage domestic companies to expand or to merge. To date, this effort has met with limited success. (One report attributed it to cultural characteristics: "Most Chinese want to be their own boss.")

The government has also tried to shift production toward more technology- and capital-intensive goods and to encourage greater domestic and foreign investment in high-tech industries. Taipei instituted a series of measures to promote investment, including infrastructure projects, tax cuts, and lower interest rates. Under its 14 Projects Plan, Taiwan is scheduled to invest \$25 billion between 1986-92 on energy, petrochemicals, transportation, communications, and steel. Despite these efforts, the Taiwanese continue to

save (at the rate of 33 percent of GNP, among the highest in the world) and to invest in traditional enterprises. To the conservative Taiwanese businessman, "high-tech means high risk." The propensity for saving, coupled with the country's underdeveloped financial markets, has caused capital investment to stagnate. Moreover, the persistence of protected markets and an archaic financial system has hurt foreign investment. As a result, Taiwan's technological advance appears stalled and the economy has failed to move into new areas.

Taiwan considers itself to be much more dependent on exports and less able to sustain a major decline in overseas sales than are Japan or Korea. (Local businesses are generally small, family-owned, with slim profit margins.) Exports account for 60 percent of the country's GDP, and because the country's remarkable growth has been largely due to its export-oriented policies, there is resistance to change. Despite recent export initiatives toward Asia and South America, Taiwan remains dependent on the U.S. market, where it sends nearly half of its exports. Like other export-oriented economies, Taiwan's markets are very protected. Recently, there have been modest trade concessions -- market openings and tariff reductions -- prompted by the U.S. threat of Section 301 cases. While tariff reductions may increase imports somewhat, they may not reduce the trade surplus significantly because most of the country's imports are processed for re-export. Moreover, Taiwanese officials have noted that market openings are likely to benefit Japanese firms, which have been more willing and better able to sell to Taiwan than has American business.

The NTD is closely linked to the U.S. dollar. Consequently, after the U.S. currency began to fall in 1985, the NTD declined against the non-dollar currencies. The relative rise in the yen has not helped Taiwan substantially in its trade with Japan, because the trade relationship is based largely on supply contracts and because Taiwan remains dependent on Japanese inputs. However, the decline of the NTD has prompted Japan to move production facilities to Taiwan and has helped Taiwan compete in third markets, particularly Europe. (Taiwan's exports to the U.K. and West Germany have increased by about 50 percent.) The lower currency (coupled with the decline in oil prices) has also given a boost to Taipei's industrialization efforts and made Taiwanese relatively more competitive against Japanese and European goods.

Taiwan runs a trade deficit with Japan. Many of Taiwan's export industries rely on high quality Japanese parts and capital equipment, and, as a result, have been hurt by the rise of the yen. Taiwan has for several years attempted, unsuccessfully, to reduce this deficit.

Taiwan's foreign debt is low (under \$4 billion) and has been declining. The country's main financial problem is management of a record level of reserves, the product of its trade surpluses and intervention in foreign exchange markets.

Because of its growing surpluses and huge foreign exchange reserves, Taiwan has become a major target of U.S. protectionism. In 1986, Taiwan had a trade surplus exceeding 15 billion (the bilateral trade surplus with the U.S. was approximately \$13.5 billion). Its tight protectionism has fueled criticism of Taiwan, which is seen as a particular offender of trade norms. Federal Reserve Board Chairman Volcker called Taiwan a "particular culprit" in trade because "it maintains restrictive practices that are certainly not appropriate today ... Countries with large trade surpluses that have many barriers to U.S. imports should be willing to reduce or eliminate the barriers." (Testimony before the Joint Economic Committee, Feb. 2, 1987.)

Recently, the U.S. has dealt aggressively in trying to ^{set} Taiwan to lower its high tariffs and grant U.S. firms greater access to its markets. (Taiwan was not targeted earlier for U.S. pressure, because of its relatively low trade profile: many of Taiwan's goods are exported under unfamiliar or American brand names.) Taiwan's structure of protection is characterized by tariffs, rather than quotas or other barriers. According to U.S. trade officials, this lends it more readily to liberalization through trade negotiations than do other protectionist measures; additionally, exchange rate changes are reflected more readily in tariff-based systems.

In 1986, Taiwan concluded a bilateral textile agreement limiting the increase in textile imports to the U.S. to 0.5 percent per year. Taiwan was the hardest hit by a USTR adjustment of the General System of Preferences, losing 37.5 percent of its benefits, probably due as much to its restrictive markets as to its status as an emerging industrial economy. (Before this, Taiwan had been the largest beneficiary, accounting for one-quarter of all imports arriving in the U.S. under the GSP, benefits generally reserved for poor nations.) Despite a per capita income of \$3,500 a year, Taiwan's position is that it is a developing country entitled to trade preferences.

Taiwan continues to use delay tactics in its dealings with the U.S. Nevertheless, there is growing realization within Taiwan of the seriousness of U.S. protectionist sentiment. (Consequently, U.S. trade officials expect to see a surge in Taiwan's exports in the next several months, ahead of any possible legislative restrictions.) The recent appreciation of the NTD and implementation of duty reductions should help U.S. exporters. U.S. business could also benefit from Taipei's efforts to upgrade its industry and expand its infrastructure. Taiwan's prosperity depends on the U.S., which is both its main export market and a major source of investment and technology. If Taipei moves to open its markets, and the Taiwanese change their consumption and investment habits, it could become a rich market for U.S. exports. As one study observes, "the economy has produced a lot of purchasing power that is just idle."

Since 1979, Taiwan has maintained a managed currency float. The rate of the New Taiwan Dollar (NTD) is determined daily, based on the previous day's average of interbank transactions and is only permitted to move 2.25 percent either way. Actual movements of the currency show that, like the Korean won, the NTD is closely linked to the U.S. dollar. However, the situation is very different from that in Korea, where capital controls and government statements virtually dictate the currency's value. In Taiwan, during an average day, the central bank buys and sells about \$150 million to maintain the NTD-U.S. dollar exchange rate.

The NTD moved with the U.S. dollar during the 1980s as it first rose then fell. In July 1986, because the NTD had not appreciated against the dollar, U.S. officials approached Taiwan about allowing its currency to float. Since that time, the NTD has risen about fourteen percent, despite unusually heavy central bank intervention in foreign exchange markets (ostensibly, to slow, not stop, the appreciation). For several months in mid-1987, the central bank bought U.S. dollars at a rate of \$3 billion per month (the dumping of U.S. dollars began in late July 1986, following U.S. statements about the exchange rate).

Heavy foreign exchange market intervention by Taiwanese authorities resumed in February 1987, under pressure from domestic exporters and trade organizations concerned about losing competitiveness against close competitors such as Korea and Hong Kong, whose currencies have appreciated little or not at all. Despite central bank action, the NTD remains under pressure from speculators, who have moved into the local foreign exchange market in anticipation of further appreciation of the currency.

Largely as a result of the large trade surplus and the sizable U.S. dollar purchases by the central bank, Taiwan's reserves have been growing at a rate of \$1 billion a month, and reached a record \$46 billion at the end of 1986. (This constitutes an unprecedented two-year import cover.)

Some observers see the country's excess liquidity as a sign that there is low confidence in the future. There has been a general unwillingness by manufacturers to invest in modernizing Taiwan's partly outdated industrial base. It also reflects Taiwan's failure to develop a proper capital market able to convert savings into investment. As a result, the country's huge export earnings flow into short term foreign securities rather than funding long term domestic investment.

Another consequence is that Taiwan's money supply has increased rapidly, growing at an annual rate of 40-50 percent. Taiwan's strict foreign exchange controls have forced authorities to convert most of the country's trade surpluses into local currency. In 1956, President Chiang, concerned about the inflationary impact of the country's foreign exchange reserves, instructed his cabinet to liberalize import controls and lower import tariffs, make buying foreign exchange easier, and encourage inward and outward investment.

Businesses are now allowed to import and export goods without applying for permits. This "internationalization and liberalization effort" is cited frequently, but opposition from bureaucrats and powerful business lobbies has slowed the move toward substantive reform.

To manage the accumulation of reserves and curb money growth, Taiwan has eased, somewhat, its very rigid foreign exchange controls, and increased the amount of gold and foreign exchange that can be retained. The central bank raised the limit of forward exchange transactions that can be sold to the central bank, to prevent the dumping of excess U.S. dollars in the open market. The government has also controlled the profits of state enterprises, and the central bank has issued debentures to absorb excess liquidity. These measures should slow the accumulation of reserves, while the recent appreciation of the NT dollar against the U.S. dollar should slow the country's export growth. However, the efforts are small in relation to the magnitude of the country's structural problems.

Despite the rapid money expansion, inflation is not considered a problem for Taiwan. In 1986, it was estimated at 2 percent. The projected rate for 1987 is 5 percent (high by Taiwanese standards). Some observers feel that a mild dose of inflation could be healthy for the economy and serve to stimulate domestic consumption. (However, the Kuomintang government, which in 1949 lost mainland China partly due to hyperinflation, remains nervous about inflation, and may be prompted to undertake reforms to reduce this threat.)

Development of Taiwan's financial sector has also lagged. In 1983-84, Taiwan launched a program to improve the country's banking system in an attempt to modernize its parochial institutions, to make them more competitive abroad and to enhance the country's international position. Operating restrictions have been eased to attract foreign financial institutions and increase domestic investment. However, its efforts were frustrated somewhat by the development of a domestic banking crisis, and foreign banks have shown some unwillingness to participate in the country's new offshore banking facility.

It has been Taiwan's policy to keep its currency artificially low to help exporters, and the government resistant to U.S. efforts to appreciate the NT dollar for fear of losing its overseas competitiveness. As Taiwanese officials note, even the substantial decline of the yen has not reduced Japan's trade surplus with the U.S. However, the government's fear of inflation could encourage them to allow the currency to rise to level off its trade surpluses and reduce its accumulation of reserves.

POLITICAL SCENARIO

Taiwan is officially the Republic of China. Chiang Kai-shek and his defeated Nationalist army created a government in exile on the island in 1949.

Today, Taiwan is governed by his son, Chiang Ching-kuo, and still dominated by the Nationalist (Kuomintang) Party. (Two minor political parties are formally organized, but have no significant influence or following.) President Chiang is considered a "benevolent dictator" who deserves much of the credit for the country's transition from a poor agrarian country to a major exporting economy.

Taiwan has been under martial law since 1948, when a revision of the constitution granted virtually unlimited emergency powers to the President. These remain in effect, and serve as the basis for the administration of strict security measures. Political opposition is considered seditious and thus can be punishable by law. Recently, there has been some movement toward greater political liberalization, but Taipei resents recent U.S. initiatives opposing martial law and supporting the existence of the country's political opposition.

President Chiang, at 76 or 77, is ailing and has no obvious successor. Observers feel his death could create a power vacuum at the top levels of government that could create instability and hurt the country's domestic and international interests. Ever cautious Taiwanese businessmen cite domestic political unease as another factor for keeping their wealth liquid.

The People's Republic of China, which claims sovereignty over the island, is an ever-present threat. International uncertainty over the PRC has affected Taiwan's management of the economy as well as the domestic business behavior. Taiwan's development strategy has been much more conservative than has Korea's. For example, the country's reserves are 90 percent U.S. dollar-denominated. (Recently, this has prompted some internal disagreement over money management, as declines in the value of the U.S. dollar have resulted in losses for the country estimated at \$1 billion.) Political uncertainties have also left the country vulnerable to capital flight.

Taiwan's international standing has deteriorated. The U.S. embassy in Taipei was officially closed in 1979 when the U.S. recognized the People's Republic of China (causing resentment, but not seriously hampering economic ties). Taiwan has official diplomatic relations with only about 20 countries, most of them small, developing nations, and is excluded from major international forums such as the IMF and the United Nations.¹⁰ Recent economic reforms in Beijing and an increasingly active foreign trade effort threaten to take business away from Taiwan.

It is argued that this international political isolation and general uncertainty is responsible for Taiwan's unprecedented buildup of reserves: shut out of international institutions and the world financial system and suffering from periodic bouts of capital flight, the Taiwanese feel they must maintain self-reliance and finance their development alone. Some see the country's reserves as a source of pride and security. However, the consensus of U.S. officials is that the country's reserve buildup is essentially the result of the country's exchange rate management, and represents a policy problem rather than a policy objective.

NOTES

¹ Taiwan has made some progress in liberalizing its financial markets. Foreign banks have been given some operating freedoms, including removal of deposit ceilings and access to short-term lending from the central bank. However, progress has been slow and limited. Denial of national treatment keeps foreign banks at a competitive disadvantage.

² Domestic investment as a percentage of GNP has declined over the past five years. Investment in non-defense research and development in Taiwan is estimated at 0.7 percent of GNP. (This compares with 2.7 percent in West Germany, 2.3 percent in Japan, and 2.0 percent in the U.S.) Gross fixed capital formation declined in 1985, by almost 7 percent, but rose modestly last year after the government began implementing the 14 Projects plan.

³ Taiwan is particularly vulnerable in the area of textiles, and was very concerned with the 1986 Jenkins Bill, later vetoed by President Reagan. Taiwan is also dependent on the U.S. for military supplies. Taiwan has undertaken a major militarization effort in response to the ever-present threat of the People's Republic of China, and the U.S. accounts for most of Taiwan's large foreign expenditures on defense.

⁴ In 1986, Taiwan dismantled its unfair system for valuing imports for customs duties and reduced by half its tariff rates on 151 textile products. Tariffs on another 1990 products will be reduced in early 1987. Immediately following the December 6 elections, Taiwan announced a change in duties on U.S. beer, wine, and tobacco imports (eliminating a major irritant in U.S.-Taiwan trade relations). The maximum tariff rate has been reduced on 4800 products to 58 percent from 67.5 percent; the stated goal is 20 percent by 1990. (The products in question were ones where Taiwan has a competitive advantage, and these tariff rates are still very high by international standards, especially on finished manufactured products and consumer items.)

Taiwan has tentatively agreed to limit its exports of machine tools and steel to the U.S. and to eliminate the rules that force foreign carmakers who invest export a part of their production. In addition, the government has moved to lower tariff barriers against auto imports in order to force the domestic auto industry to increase its productivity and quality. Taiwanese officials concede that protectionism can hurt domestic productivity, but these concessions have not been translated into significant reforms.

⁵ This includes an attempt to develop an automobile industry. To date, Taiwan has been an assembler, rather than producer, of automobiles.

⁶ Taiwan poses a negotiating challenge for the U.S. The U.S. has not had formal relations with Taiwan since the U.S. recognized the People's Republic of China in 1979. The Taiwan Relations Act governs all official contacts. In their ongoing negotiations, Treasury officials have conferred with State Department officials to ensure the requirements of the Act are met.

⁷ In November 1986, Taiwan liberalized its gold import and trading regulations to deflate its money growth by encouraging gold purchases. This officially relinquished the financial authorities' traditional monopoly over gold trade. A recent State Department cable expressed skepticism that these measures will have the intended effect of increasing gold imports and taking some of the pressure off the money supply, due to the previous high level of illegal (but condoned) gold imports. However, it does signal a willingness of the part of conservative authorities to undertake difficult steps to manage the country's surpluses.

Other measures taken include granting an increase in the amount of gold and foreign exchange transactions that can be retained by nationals. Prohibitions on the trade of foreign currencies and negotiable instruments have been lifted, and individuals may remit a limited amount of foreign exchange overseas. The central bank has raised the limit on foreign exchange transactions that can be sold to the central bank to keep banks from dumping excess U.S. dollars in the market. And companies no longer need central bank approval before engaging in foreign trade transactions, to give traders more freedom and flexibility in managing their foreign exchange.

⁸ In 1985, runs on two of Taiwan's banks and the revelation of scandals and illegal operations resulted in mass bankruptcies, several government resignations, and a sharp tightening of domestic credit by local and foreign institutions.

⁹ Beijing has offered to conclude an agreement based on equality of status, in exchange for China's sovereignty over the island. (Taiwan has refused to negotiate.) Chinese leader Deng Xiaoping, however, has said he does not rule out the possibility of a blockade or an invasion of the island.

¹⁰ Taiwan has cultivated informal ties with many countries in an attempt to offset its growing isolation. Many nations have set up unofficial embassies. The U.S. embassy continues to function under the name of the American Institute in Taiwan (AIT), which handles U.S.-Taiwan relations. Taipei's counterpart in the U.S. is the Coordination Council for North American Affairs (CCNAA).

ASIAN NICS: TRADE AND RESERVES*
(U.S. \$Million)

(U.S. \$Million)	1980	1981	1982	1983	1984	1985	1986	Q-1/86	Q-11/86	Q-111/86
KOREA										
Exports	17,505	21,271	21,627	24,471	28,090	26,442	31,000	---	---	---
Imports	22,289	26,155	24,250	26,196	30,796	26,461	29,100	---	---	---
Trade Balance	-4,784	-4,884	-2,623	-1,725	-2,706	-19	1,899	-572	841	1,026
% Change	-9.7	2.1	-50.4	-28.8	56.9	-99.1	2500.5	-576.1	185.8	22.0
Trade Balance/ GDP	-6.1	-7.1	-1.8	-2.8	-4.2	0	4.6	-4.2	5.1	---
Trade Balance with U.S.	-26.7	-36.2	3.9	1,984	1,211	5,997	7,200	1,118	1,417	1,970
% Change	24.8	35.6	290.9	501.0	61.0	21.6	-80.0	4.9	7.5	19.0
Reserves	2,925	2,682	7,807	2,347	2,754	2,869	3,800	2,617	2,714	1,827
% Change	-1.1	-8.1	4.1	-16.4	17.1	4.2	32.4	-8.8	1.7	-41.0
Reserves/GDP	1.7	4.0	4.4	3.8	4.1	4.6	5.6	---	---	---
Reserves/Months Imports	1.6	1.2	1.4	1.1	1.1	1.1	1.6	---	---	---
TAIWAN										
Exports	19,575	22,408	21,776	25,028	30,185	30,456	37,174	---	---	---
Imports	19,498	20,581	18,110	18,760	20,952	19,249	22,058	---	---	---
Trade Balance	77	1,827	3,666	6,268	9,233	11,217	15,116	1,289	1,942	1,829
% Change	94.2	2,270.1	99.9	71.9	47.1	21.5	34.8	19.4	19.9	-2.9
Trade Balance/ GDP	0.2	3.8	7.7	12.1	16.2	19.0	20.5	20.9	23.0	---
Trade Balance with U.S.	2,069	3,465	4,117	6,537	9,765	11,697	13,500	2,938	1,462	1,470
% Change	8.4	6.7	24.9	51.4	49.4	19.9	15.4	8.4	17.8	0.2
Reserves	2,205	7,235	8,552	11,859	15,664	22,556	46,050	26,027	30,851	11,580
% Change	56.4	238.1	17.9	40.0	32.1	44.0	99.7	15.4	16.5	21.8
Reserves/GDP	5.4	15.2	17.9	21.1	27.5	38.1	61.1	---	---	---
Reserves/Months Imports	1.1	4.2	5.6	7.6	9.0	14.1	25.0	---	---	---

* Trade data is based on customs value for imports.

ASIAN NICS: TRADE AND RESERVES*
(U.S. \$Million)

	1980	1981	1982	1983	1984	1985	1986	Q-1/86	Q-11/86	Q-111/86
SINGAPORE										
Exports	19,175	20,967	20,768	21,811	24,070	22,806	21,000	---	---	---
Imports	24,011	27,571	28,176	28,760	28,667	26,278	24,000	---	---	---
Trade Balance	-4,836	-6,604	-7,408	-6,949	-4,597	-1,472	-1,000	-962	-506	-700
% Change	36.0	42.4	11.9	-14.4	-27.1	-24.5	-13.6	-7.4	47.4	-40.0
Trade Balance/ GDP	-40.9	-68.6	-69.5	-37.9	-24.5	-19.9	-16.8	---	---	---
Trade Balance with U.S.	-965	-714	-1,020	-107	644	838	1,100	164	197	---
% Change	72.1	-26.0	42.9	-69.9	409.8	30.1	31.1	-41.6	142.1	-32.0
Reserves	6,557	7,549	8,480	9,264	10,476	12,847	13,500	12,559	12,717	11,200
% Change	12.8	15.1	12.1	9.2	12.4	21.3	5.1	-2.8	1.3	3.8
Reserves/GDP	57.8	55.5	56.8	55.6	55.4	71.5	75.7	---	---	---
Reserves/Months Imports	1.1	1.1	1.6	1.9	4.4	5.9	6.8	---	---	---
HONG KONG**										
Exports	19,724	21,796	20,996	21,951	28,118	30,185	32,600	---	---	---
Imports	22,401	24,694	23,544	24,011	28,561	29,706	32,082	---	---	---
Trade Balance	-2,677	-2,898	-2,548	-2,059	-4,443	-4,521	-4,482	---	---	---
% Change	15.4	8.2	-12.1	-19.2	-88.1	-19.5	8.1	---	---	---
Trade Balance/ GDP	-11.8	-9.8	-8.1	-7.2	-8.8	-1.4	1.4	---	---	---
Trade Balance with U.S.	2,504	1,486	3,525	6,432	6,284	6,488	7,585	1,291	1,230	1,652
% Change	20.6	39.2	1.1	25.7	41.8	1.2	16.9	-18.7	-4.9	14.1

* Trade data is based on customs value for imports.

** Hong Kong does not release reserve numbers.

HONG KONG

ECONOMIC STRUCTURE

After a 1982-83 economic slump (caused by concern over the future of the colony), the Sino-British accords of 1984 helped Hong Kong to return to a healthy rate of growth.

The main sources of the colony's success has been its location and free port, coupled with its international financial status and the international position of the Hong Kong dollar. Unlike its Asian neighbors, Hong Kong has maintained a free-market economy, with few official controls or regulations. There is minimal government interference in the economy, and the fiscal system is based on low taxes and high prosperity.

Because of its size (about 5.3 million people), Hong Kong must tread a thin line between diversification and specialization. However, it is twice the size of Singapore, and have been able to develop competitive industries.

Hong Kong is a free trading nation. The colony is very dependent on trade, and imports virtually everything it consumes. Foreign trade turnover is twice as large as the colony's GDP. However, U.S. imports accounted for only 9 percent of the colony's 1986 imports. U.S. importers have considered the colony too small a market to be worthy of a major trade promotion effort. Hong Kong's trade surplus with the U.S. been growing, particularly in garments and textiles. In 1986, it reached \$7 billion, well above the country's overall trade surplus of \$500 million. The decline of the Hong Kong dollar against non-dollar currencies has helped exports to third markets such as Europe and Japan.

In February 1987, Hong Kong announced the start of a campaign to increase American imports. The colony is eager to establish itself as a gateway to the vast Chinese market. (China is now Hong Kong's second most important trading partner, after the U.S.) This may make Hong Kong a rich market for exports.

In July 1986, Hong Kong agreed to limit the growth of its textiles and apparel exports to the U.S. to about one percent a year through 1991. (The administration had hoped to freeze exports at current levels for three years; there is speculation that U.S. negotiators were not able to achieve this because they lost the threat of worse sanctions when it became apparent that would not override the veto of legislation to limit textile imports.) The colony remains concerned about U.S. intent in the areas of exchange rates and textile imports. The exchange rate issue is a particular concern, as Hong Kong is intensely concerned with preserving stability.

Since 1983, The Hong Kong dollar has been directly pegged to the U.S. dollar at the rate of HK\$7.80=US\$1. The goal of this policy has been to discourage speculation and volatility. The exchange arrangements require that non-issuing banks pay a fixed amount to the Hong Kong government exchange fund for each Hong Kong dollar issued. This has the effect of stabilizing the exchange rate at the pegged level.

As the U.S. dollar has fallen, the Hong Kong dollar has declined on a trade-weighted basis. As with the U.S. dollar, the decline has been particularly great against the yen and the DM. In defense of the exchange regime, Hong Kong's financial authorities argue that it creates "as stable a monetary environment as is obtainable in Hong Kong's circumstances." (Like Taiwan, Hong Kong is not a member of the IMF and not subject to rules set forth in the Fund's Articles of Agreement. Hong Kong also lacks a "lender-of-last-resort.")

At present, there are no U.S. cabinet-level discussions with Hong Kong on the issue of exchange rates. However, Hong Kong is said to be concerned about Congressional intent in this area. Recently, the local currency has appreciated in the market as speculators have bought Hong Kong dollars hoping the peg will be changed. Hong Kong says it cannot revalue the Hong Kong dollar because this will encourage speculation that it will happen again. In its financial management, the Hong Kong government sees stability as the driving force.

Hong Kong has a free foreign exchange market. Since 1973, there have been no foreign exchange controls or regulations. This, coupled with a dynamic economy and competent political and financial leadership, has attracted foreign financial institutions and helped to transform the colony into a thriving financial center.

Domestically, Hong Kong has an antiquated banking system. U.S. and other foreign banks are trying to get a foothold. The financial system has been hurt by political developments, particularly concerns over the transfer of power to the People's Republic of China (PRC). Efforts to liberalize and modernize the system were stalled in 1985 in the wake of a financial crisis that saw several scandals and the collapse of dozens of financial institutions.

Hong Kong's financial market problems have not hurt its reputation as an international financial center, which is based by the colony's location and excellent communications system, coupled with a liberal tax climate and the absence of red tape.

Because of its dependent status, Hong Kong has no central bank to oversee the financial system, and has no published balance of payments or reserve statistics. Reserves are estimated to be in the range of \$5 billion.

ECONOMIC STRUCTURE

Hong Kong is a British dependent territory ruled by a governor who is appointed by Britain. In 1997, the colony will become a "Special Administrative Region" (SAR) of the People's Republic of China, under a Sino-British agreement reached in 1984. According to the terms of the agreement, Hong Kong is to "enjoy a high degree of autonomy." The capitalist and legal systems will be preserved until the year 2047. Nevertheless, some concern over whether the PRC will abide by these conditions remains.

NOTES

¹ In terms of number of syndicated loans, Hong Kong ranks third in the world as an international financial center. ~~Bank of China~~ ranks fourth as a gold trading center. Hong Kong's financial and business services sector contributes nearly 25 percent to the economy's GDP.

Singapore's economy has endured a deeper decline and slower recovery than have the economies of the other Asian newly industrializing economies. After 20 years of 10 percent growth rates, a slump in Singapore's main export markets (particularly the U.S.), coupled with the country's own overheated plans, produced an economic decline (almost 2 percent in 1985). Singapore had positive growth in 1986, but no one expects a return to the spectacular growth of earlier days.

Because of the country's small size and dependence on foreign trade (turnover is equivalent to three-times the country's GNP), there are few domestic measures the government can use to stimulate recovery. Exports account for two-thirds of the country's output of goods and services. Despite the recent slowdown, Singapore remains a relatively wealthy nation, with annual per capita income of over \$7000 (the highest among the Asian NICs) and reserves are estimated at \$13 billion (this is large, given the country's size).

Singapore's trade picture is different from that of the other NICs. The country, which has few natural resources and too small a population to sustain economic growth, designed its economy around importing to and exporting from its resource-rich Asian neighbors. (Its efficient bureaucracy and disciplined labor force make this work.) Singapore also handles their money: in the last two decades, it has transformed itself into a center for business, industry, and finance, with an excellent communications link to the rest of the world.

Singapore traditionally runs a deficit in its merchandise trade account (the deficit was \$3 billion in 1986), which is largely offset by service earnings. Recently, the bilateral trade balance with the U.S. has been in surplus only since 1984; in 1986 it reached a relatively modest \$1.1 billion. Until foreign investment declined in 1984, capital flows kept Singapore's balance of payments in surplus.

Singapore's savings rate is one of the highest in the world, the result in part, of a mandatory contribution to the country's "Central Provident Fund" (or CPF). In 1985, net contributions to the CPF equalled 17 percent of gross national savings. The CPF funneled the country's savings into ambitious public sector investment projects; when supply exceeded demand, the country slid into a recession.

Some of the country's current problems stem from its "wage correction policy." Initiated in 1979, the program tried to achieve a standard of living comparable to that of Japan by raising wages and forcing employers to shift into high-tech and capital-intensive production. However, other Asian developing countries, notably Korea and Taiwan, also moved up-market with much

lower labor costs. This wage policy, coupled with a relatively high exchange rate, priced Singapore out of international markets. Government planning and high taxes also dampened the country's other engine of growth -- investment by multinational corporations. (Singapore has experienced large capital outflows since 1984 due to the drastic economic slowdown and the lack of new lending opportunities.) The economy has also been hurt by the prevalence of uncompetitive sunset industries.

In response to the decline, the government has backed away somewhat from central planning. Labor costs have been frozen (future wage increases should reward productivity gains) and taxes cut. In addition to attracting foreign investment, Singapore has adopted more measures to promote local entrepreneurs. The government has sold hundreds of publicly-owned corporations and reduced contributions to the CPF, the forced savings plan that financed years of public spending projects. Today, U.S. Treasury officials see Singapore's economy as being in relatively good shape as a whole.

The country's currency is closely linked to the U.S. dollar. In the early-to-mid 1980s, as the U.S. dollar rose, the Singapore dollar rose against its other major trading partners. This hurt the country's export competitiveness and exacerbated the economic decline. After 1985, the Singapore dollar depreciated against the yen and other non-dollar currencies. Last year, the economy benefitted from the stronger yen, which helped to stimulate exports, and falling oil prices reduced import costs. (Singapore imports heavily from Japan, and thus has been hurt somewhat by the appreciation of the yen. The Japanese import bill rose ten percent in 1986, probably due to price rather than volume changes.)

Singapore has relatively open trade and financial markets. There are tariffs but no taxes on trade. Most of the country's trade barriers are in the form of quantitative restrictions (primarily on food, beverages, and tobacco and miscellaneous manufactures).

Singapore is fairly dependent on the U.S., where it sends 20 percent of its exports. (The country's three largest trading partners -- the U.S., Japan and Malaysia -- account for half of its total trade.) The 1986 trade surplus with the U.S. is estimated at \$1.5 billion (although the high degree of re-exports and U.S. direct investment makes it difficult to get a true measure of the bilateral trade balance).

In 1986, Singapore received an increase in GSP benefits from the U.S. because of its open trading system. Concern about the possibility losing more of its duty free status under the GSP prompted Singapore to set up a trade office in Washington in 1986.

Officially, the Singapore dollar is permitted to float, but the monetary authority monitors its value against a trade-weighted basket of currencies. The basket is heavily weighted against the U.S. dollar, and the Singapore dollar has moved closely with the U.S. currency. (Recently, the Singapore dollar has risen slightly against the U.S. dollar, but the current level is less than one percent above the level at the end of February 1985, when the U.S. dollar began to fall.) In 1986, the Ministry for Trade and Industry pronounced that "the exchange rate should continue to be set by market forces, but its impact on our export competitiveness should be taken into account."

The Singapore dollar is rigidly managed by the Monetary Authority of Singapore (MAS), which observers feel is determined to uphold the currency's value to protect the country's status as a financial center. (Singapore likes to track the U.S. dollar because of the high degree of foreign direct investment -- this reduces foreign exchange risks for MNCs.) It is difficult to determine whether there has been central bank intervention to support the Singapore dollar; Singapore has large reserves, but it also has large capital flows.

The Singapore dollar rose with the U.S. dollar against other currencies. In 1986, the International Monetary Fund told Singapore its currency was overvalued and suggested that the rate determination be given more flexibility. In August 1986, Treasury Secretary Baker met with Singapore's Finance Minister to discuss the issue of exchange rates. The message, according to the Treasury Singapore desk officer, was passive, essentially that one "should not use exchange rates in a predatory fashion."

The country's overvalued exchange rate has been partially blamed for Singapore's export slump. In 1986, as the U.S. dollar declined, the currency declined on a trade-weighted basis against the country's major partners. This restored some export competitiveness and helped the economy return to positive growth.

Singapore transformed itself into an international financial center through its liberal tax laws and banking incentives, as well as its location and long tradition of political stability. In 1968, the MAS decided to expand Singapore's foreign money market. The purpose of this market was to channel U.S. dollars to Pacific Rim countries in need of both foreign investment funds and facilities for deposits. This was the beginning of the Asian dollar market, which has grown dramatically in recent years.

POLITICAL SCENARIO

Singapore has been governed for 28 years by Prime Minister Lee Kuan Yew, who led the country out of poverty and into a free trade regime and prosperity. Singapore, which was established in 1819 by Sir Stamford Raffles as a trading port for the East India Company, achieved internal self government

in 1959 under Lee's Political Action Party (PAP), and became an independent republic in 1965.

The leadership of Prime Minister has been characterized as "firm and unquestioned, if benevolent, paternalism." The People's Action Party dominates the bureaucracy and the economy, and Prime Minister Lee dominates the Party. There is no parliamentary opposition. However, the government is honest, and is credited with achieving the prosperity that Singapore now enjoys.

Lee, who is only 63, had announced that he will retire in 1988. Lee's son, Brigadier General Lee Hsien Loong, presently the acting minister of trade and industry, is seen as a likely successor. However, the elder Lee now talks of staying on until the economy regains its health, and may exchange his role as Prime Minister for President when his current term expires. (Legislation to strengthen the presidency is currently being drafted.)

However, fueled by the country's economic problems, there is growing disaffection with the governments omnipresence. According to one local scholar, "the people want more communicative, less authoritarian [leaders] ... they want an economy with fewer rules and regulations -- more room for entrepreneurship." The depth of recession may force Singapore to adopt political as well as economic reforms.

NOTES

¹ In 1985, the Singapore government introduced a series of stimulation packages to spur economic growth. The measures included lower taxes, lower interest rates on loans to small businesses, increased public works spending, and the establishment of a fund to promote local development. To date, these had little overall impact.

² In the words of Singapore's Prime Minister Lee Kuan Yew, "this is how a country succeeds: you pick winners; you concentrate on those items, on those skills, on those products which will sweep the market." Using a series of blueprints, the government selected areas that became winners, such as ship building and repairing, oil-rig building, and electronics. It developed business-promoting infrastructure, including excellent airline, postal, and communications services. And it avoided areas vulnerable to regional competition and western protectionism, such as textiles.

³ Singapore kept its exchange rate high to keep the country's import costs down. The government also safeguards its currency's peg to the U.S. dollar in order to attract multinational corporations and foreign investment.

⁴ Singapore was responsive to U.S. calls for stricter copyright laws.

APPENDIX A INTERNATIONAL MONETARY REFORM PROPOSALS

The exchange rate volatility experienced since the Bretton Woods par value system was abandoned in 1973 has prompted much criticism and calls for reforms or modifications of the existing exchange rate arrangements. The main proposals for improving the functioning of the system include:

- (1) Gold standard (or other rigid par value system): Supporters claim convertibility would eliminate currency misalignments by tying currencies to a real asset (or basket of goods). A gold standard would eliminate the reserve currency role of the U.S. dollar, which boosts dollar demand. Would require regular government intervention to maintain the rates.
- (2) Capital controls: To restrict international capital movements to reduce exchange rate volatility. Based on the view that a country's exchange rate no longer reflects its economic strength, but the amount of capital that moves in and out of its currency.
- (3) Purchasing power parity: Adjust exchange rates to match inflation differentials.
- (4) Target zones system: Agreement among national authorities to keep currencies within predetermined ranges around an adjustable set of exchange rates seen as consistent with sustainable balances, in order to reduce exchange rate volatility and overshooting, and to impose discipline on nations. Most proponents limit the system to the large industrial nations. Would be maintained through monetary policies, reinforced by exchange rate intervention.
- (5) International policy cooperation: Agreement among national authorities to coordinate domestic policies in order to maintain stable exchange rates.
- (6) Pure floating exchange rate system: To allow market forces to determine the value of currencies. Based on the view that the value of the dollar is a symptom of domestic problems, and that productivity growth, not a dollar decline, is the solution to the competitiveness problem.

It has been observed that a credible exchange rate system must acknowledge the "current economic realities." Among these are the changing power structure of the international economy, near complete capital market integration, and the vulnerability of domestic monetary policies to external variables. It is also necessary to determine and take into account just "what the system is supposed to do." To be workable, the rules of the system must be monitorable and enforceable, pursue objectives that are consistent with political will, and be attainable with the instruments available. (Alexander M. Swoboda, "Credibility and Viability in International Monetary Arrangements," 1986.)

APPENDIX B
INTERNATIONAL MONETARY FUND

The International Monetary Fund is charged with overseeing the international monetary system in order to ensure its effective operation and provide a framework that facilitates the exchange of goods, services, and capital. In keeping with this, the Fund exercises "surveillance" over the exchange rate policies of members and oversees the compliance of each member with its "obligations" according to the principles and procedures defined in the Articles of Agreement. These are not rigid criteria, and it is the Fund's position that no single system is appropriate for all times and circumstances.

According to the Articles, Fund members must endeavor to pursue economic growth and reasonable price stability; must avoid manipulating exchange rates so as to prevent adjustment of payments imbalances or gain unfair competitive advantage; and must intervene if necessary in the exchange market to counter disorderly conditions. These are characterized as 'norms' rather than hard rules, and members are allowed wide latitude in their choice of exchange rate regime. Members are also obligated to collaborate with the Fund and other members to promote a stable system of exchange rates.

The Fund monitors member policies and adherence to norms. Procedurally, its basic vehicle is member consultation. The Fund will enter into discussions if it perceives (1) persistent sales or purchases of foreign exchange, (2) an unsustainable level of official borrowing or lending for balance of payments or domestic economic purposes, (3) prolonged restriction on trade or capital flows, (4) abnormal incentives for capital inflow or outflow, or (5) exchange rate behavior that seems unrelated to underlying economic and financial conditions. (This does not apply to countries such as Taiwan and Hong Kong, which are not members of the IMF.)

The Fund also undertakes broader reviews of economic developments and policies in the context of Executive Board discussions of world economic outlook. In addition, members can call for special consultations between the Fund and other members who may be violating the Articles rules. However, this action would likely be seen as "economic warfare, and might do more harm than good."

Concerns about the effectiveness of the Fund's surveillance efforts have been raised. The Fund can focus global attention on issues or problems by addressing them in its publications. There is no requirement that the Fund and a member reach agreement on the appropriateness of exchange rate behavior. To that end, the effectiveness of surveillance rests on the Fund's persuasive ability, and critics contend that it has more influence on countries that rely on it for adjustment support.

APPENDIX C
CHRONOLOGY OF ECONOMIC COORDINATION EFFORTS

- Sep 1985: G5 agreement to coordinate economic policies and exchange rate behavior. Allowed that "some further orderly appreciation of the non-dollar currencies against the U.S. dollar is desirable." Program includes foreign exchange market intervention, stimulative package in Europe, and continued deficit fighting in the U.S. Devised as a long term effort aimed at the fundamentals, to promote balanced growth, reduce imbalances and resist protectionism.
- Jan 1986: Secret G5 meeting in London, believed to have been intended to set in motion a coordinated reduction of central bank interest rates and to consider broadening future negotiations to include Canada and Italy.
- Feb 1986: State of the Union message, in which President Reagan said, "We've begun coordinating economic and monetary policy among our major trading partners. But there is more to do. I am directing Treasury Secretary Jim Baker to determine if the nations of the world should convene to discuss the role and relationship of our currencies."
- May 1986: Economic declaration following Tokyo economic summit, reflecting agreement to engage in "close and continuous coordination of national policies." Called on the Finance Ministers of the summit countries to prepare a report outlining joint objectives and quantitative indicators to be presented at the 1987 economic summit.
- Oct 1986: Baker-Miyazawa (short-lived) agreement to stabilize the yen-dollar rate in exchange for a stimulative economic program in Japan.
- Jan 1987: Baker-Miyazawa meeting, leading to reports of a bilateral agreement on a "reference zone" for the yen-dollar rate. Baker refuses to make firm pledge until Japan undertakes "credible" fiscal action.
- Feb 1987: The most recent attempt to institutionalize economic coordination. G6 pledge to cooperate closely to foster stability of exchange rates around current levels. Reflects conclusion that further U.S. dollar decline could be counterproductive. Includes commitments of fiscal stimulus by Japan and Germany and reduction of the federal budget deficit by the U.S. Represents the first multilateral statement regarding the exchange rates of the NICs.

U.S. Trade with Asian NICs¹⁾
(U.S. \$ Billions)

	1980	1981	1982	1983	1984	1985	22-111-35	1986 ²⁾
<u>TOTAL TRADE SURPLUS</u>	-25.3	-28.2	-16.4	-42.2	-59.1	-74.4	-109.9	-170.2
with oil-importing NICs	-0.6	-4.7	-7.8	-18.2	-32.5	-29.2	-28.3	
with Japan	-10.4	-15.8	-17.0	-27.1	-37.0	-43.2	-59.4	-58.7
with Asian NICs	-3.6	-6.2	-7.4	-11.4	-19.0	-27.4	-27.7	-29.4
(Hong Kong)	-2.1	-2.8	-3.7	-3.8	-5.1	-5.2	-4.1	-7.5
(Korea)	0.2	-0.1	-0.4	-1.5	-1.7	-4.3	-5.3	-7.2
(Singapore)	1.1	0.3	1.0	0.8	-0.2	-0.7	-0.8	-7.1
(Thailand)	-2.8	-4.0	-4.9	-6.9	-10.0	-11.2	-10.4	-11.5

Sources: June 1986, September 1986, and December 1986 Survey of Current Business; BIA.

1. Numbers are adjusted to balance of payments basis.
2. 1986 estimates are based on customs value, which sufficiently reflect balance of payments based trends.

REVIEW OF THE WORLD SUGAR SITUATION, 1986

PREPARED FOR
THE DOMESTIC SUGAR INDUSTRY

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REVIEW OF THE WORLD SUGAR SITUATION, 1986

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SUMMARY

In mid-1986, the world sweetener market continues to be in economic and political disarray. Production in 1985/86 fell short of consumption, and prices have strengthened from the historic low levels of mid-1985. The 1985 changes appear to have been due to moderate consumption increases, primarily in developing countries and production shortfalls due to weather damage in several important production areas.

World sugar production, consumption and prices continue to be dominated by the policies of important trading nations who intervene continually in domestic and world markets to protect domestic producers and consumers. As a result, production has not adjusted adequately in response to recent low prices. Sugar area for the coming harvest will increase once again, as it has through the 1970s and 1980s, in spite of prices continuing far below the cost of production for any major exporter.

In this context, the United States has continued for the 1986-90 crops the sugar policies it began in 1981. Those policies resulted in stable raw sugar prices during the past 4 years in spite of low world prices and intense domestic competition for the caloric sweetener market. High fructose corn sweeteners (HFCS) have replaced sugar in most products that are able to use liquid sweeteners. HFCS has accounted for all of the growth in caloric sweetener use in recent years, and has reduced sugar use nearly 20 percent from the 1981 level. Sugar imports that were 4.6 million metric tons (mmt) in 1981 were reduced to 2.5 mmt in 1985.

In the absence of the 1981 program, domestic prices of raw and refined sugar and HFCS would have been sharply lower, driven down by continuing low

world prices. In response, domestic sugar production would have declined to 2 mmt or less. HFCS production would have continued to expand, but at a much slower pace. Sugar imports would have increased nearly 60 percent to more than 7 mmt.

World prices would have been stronger in the absence of the U.S. program in response to the decline in U.S. production and the resulting increase in imports.

U.S. sugar programs traditionally have been of vital importance to Caribbean sugar exporters, especially the Dominican Republic and Guatemala who account for almost half of the region's exports. Since the early 1980s, the region has been under intense economic pressure from declining revenues and increasing debt service costs. Total export revenues for the 13 major sugar exporters has declined from \$12.2 billion in 1980 to \$7.9 billion in 1985.

Sugar exports also declined during the period. Nevertheless, sugar revenues have fallen less rapidly than those from other commodities. They accounted for 8.5 percent of export revenues in 1985, up from the 8 percent they were in 1980.

The absence of the U.S. program would have increased access to the U.S. market for these exporters, but lower U.S. prices would have diminished the value of that access. For the past 3 years, prices of Caribbean sugar sold in the United States have averaged 19.9 cents per pound, while those on world markets averaged 6.1 cents per pound. Had there been no U.S. sugar program, the loss of the protected U.S. market would have reduced revenues for Caribbean sugar exporters by about \$60 million annually in spite of somewhat higher world prices.

Because the region's export revenue declines were the result of falling prices for many commodities in addition to sugar and because problems in the world sugar economy are the result of policies of sugar producers and consumers worldwide, the absence of the U.S. sugar program would have left the Caribbean region's severe economic problems little changed. Because world sugar prices likely would have continued below cost of production in the region, the end of the U.S. program would have provided no opportunity for relief by expanding sugar exports.

The absence of the 1981 program would have had extremely serious consequences for sugar and HFCS producers in the United States, and for government costs. During the 4 years 1982-85, it would have reduced sales of U.S. sugar, HFCS, and corn by \$10.5 billion. It would have increased government farm program costs (net of increased revenues from sugar import duties) by about \$1 billion. The beneficiaries would have been sugar importers and refiners in the United States, and the world's major exporters with the lion's share going to those nations such as the EEC who held export levels high by means of government intervention.

In spite of the importance of the U.S. market to Caribbean exporters, a major determinant of sugar export revenues is the world market price. As long as world prices are held at low levels by the production, consumption, and export policies of the world's large traders, Caribbean sugar export revenues likely will continue under heavy pressure.

BACKGROUND

In mid-1986, the world sweetener market continues to be in economic and political disarray. Prices are stronger than a few months earlier but still below the cost of production for any major exporter. All important exporting and importing nations continue to intervene continually in their domestic markets. The failure of world producers and consumers to respond to market changes, especially price declines since 1982, can be expected to continue to cause extreme world price variation.

In 1985, record stocks levels pushed prices to 2.7 cents per pound in July, an all-time low level in real terms. Since then prices have strengthened in response to estimates of 1985/86 consumption in excess of production for the first time in 5 years (Chart 1).

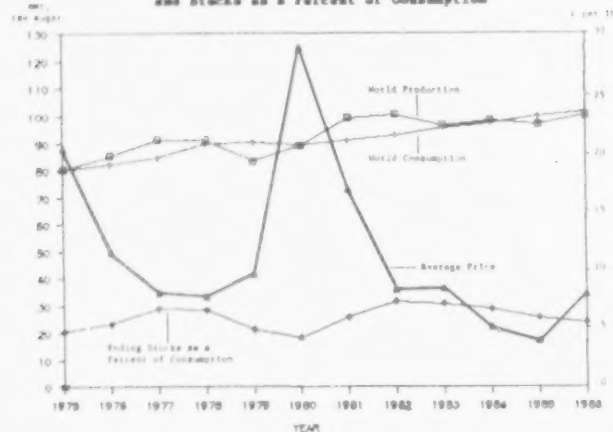
Production

A major cause of the price strength in late 1985 and 1986 appears to be production shortfalls in major producing areas. Cuban production was hurt first by drought and then by Hurricane Kate. Production was damaged by dry weather in India, the Dominican Republic, Pakistan, and Brazil. For the world, production will be about 96.9 million metric tons (mmt) in crop year 1985/86, down from 98.4 mmt in 1984/85 (Appendix I).

Following the large increases in area in the 1970s, recent production has been relatively flat, with most changes due to weather (Chart 1). Several large exporters including Brazil, Argentina, and the Philippines have announced future plans to reduce production and exports, but recent price improvements could alter those plans. Whether world prices stabilize at levels at or near the cost of production for exporters or continue under heavy

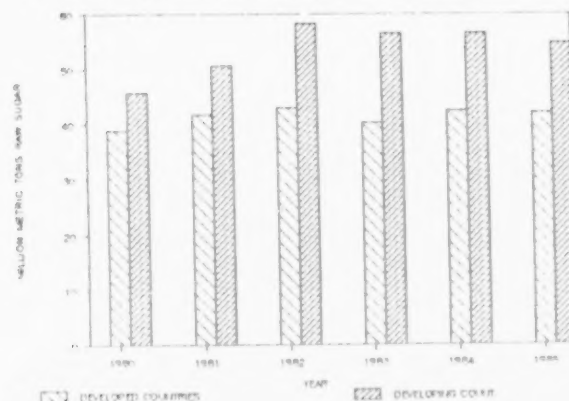
pressure from large stocks depends on traders' willingness to adjust their policies.

Chart 1. World Sugar: Production, Consumption, Prices, and Stocks as a Percent of Consumption



The largest increases in production during the early 1980s came in the developing countries, especially in Asia and in the North Africa and Middle East region (Chart 2). Production in developing countries increased until 1982, but has declined slowly since then. The developed countries, by contrast, had increased production sharply in the late 1970s and early 1980s and appear to have maintained those levels even as world prices reached record

Chart 2. Sugar Production in Developed and Developing Countries



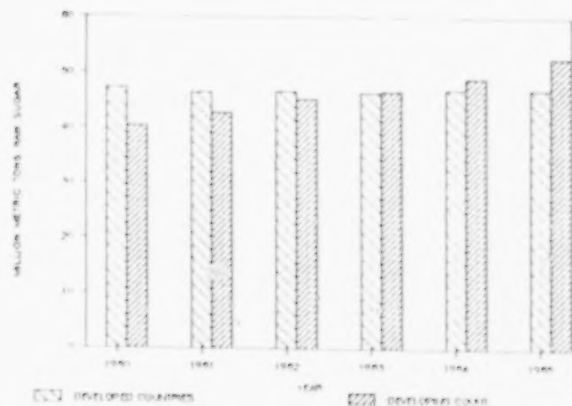
Consumption

A key part of the recent price strength has come from demand growth. Consumption increased 2.3 mmt in crop year 1985/86, substantially more than previously expected (Appendix I). Consumption growth in recent years has been largely limited to developing countries, while growth in developed countries has been very slow or negative (Chart 3). Developed countries as a group consumed about the same amount of sugar in 1985/86 as in 1980, while developing countries consumed 30 percent more.

While the increases in production were general and affected both developed and developing countries, consumption changes were much more variable (Table 1). Especially in developed countries, stable regional consumption patterns masked sharp offsetting trends. Large consumption decreases in North America, the EEC, and Japan were offset by increases in the

Centrally Planned European nations and South Africa. In developing regions, by contrast, the increases were large in all regions.

Chart 3. Sugar Consumption in Developed and Developing Countries



The shift in world sugar market shares from developed to developing countries has been a longstanding trend and has increased sugar market sensitivity to economic pressures from slow or declining growth, high debt service costs, and shortages of foreign exchange. The resumption of economic growth in these countries in 1984 and 1985 is increasing world sugar demand once again, although at rates below those of the late 1970s (Table 2).

Table 1. Sugar Production and Consumption, 1980 and 1985, by Principal Regions

Region	Production			Consumption		
	1980	1985	Change	1980	1985	Change
	(mmt, raw value)	(t)		(mmt, raw value)	(t)	
Developed						
North America	5.4	5.4	0	10.2	8.5	-17
EEC	13.5	13.4	1	11.0	10.5	-5
Other Western Europe	2.0	2.1	5	2.9	2.9	0
USSR	7.2	8.8	22	12.3	13.6	11
Eastern Europe	4.7	5.7	23	5.5	6.0	9
Japan	0.8	0.9	13	3.0	2.8	-7
South Africa	1.8	2.5	39	1.3	1.4	8
Oceania	3.6	3.6	6	1.1	1.2	4
Subtotal	38.9	42.4	9	47.4	46.9	-1
Developing						
Latin America	26.0	27.9	7	15.7	16.5	5
North Africa/Middle East	2.6	3.9	50	6.5	8.4	29
East Asia	4.4	5.7	30	4.6	5.2	13
South Asia	5.4	8.3	54	6.2	10.8	74
Asian Centrally Planned	3.7	5.5	49	4.4	6.8	55
Other Oceania	0.5	0.5	0	0.1		
Sub-Saharan Africa	3.2	3.8	19	3.1	3.5	16
Subtotal	45.7	55.7	22	40.5	51.3	27
TOTAL	84.6	98.1	16	87.9	98.2	12

Source: ISO.

Table 2. Share of World Sugar Consumption

Item	1980	1985
	(percent)	
Developed Countries	54	48
Developing Countries	46	52
Total	100	100

Source: ISO.

Trade

The world depended on trade for 28 percent of its consumption in 1985, substantially less than it did in 1980 when 36.3 percent was imported. The decline has been primarily the result of policies in developed countries which cut imports from 15.5 mmt in 1980 to 14.1 mmt in 1985 (Table 3). Developing countries, by contrast, increased imports by 1.1 mmt during the same period.

Table 3. Sugar Trade, 1980 and 1985,
by Principal Regions

Region	1980			1985		
	Imports	Exports	Net	Imports	Exports	Net
	- million metric tons, raw value -					
<u>Developed</u>						
North America	4.7	0.6	-4.1	3.6	0.3	-3.3
EEC	1.4	4.3	2.9	1.5	4.2	2.7
Other Western Europe	0.9	0.2	-0.7	0.8	0.7	-0.6
USSR	5.0	0.2	-4.8	4.9	0.2	-4.7
Eastern Europe	0.8	0.8	0	1.0	0.6	-0.4
Japan	2.4	0	-2.4	1.9	0	-1.9
South Africa	0	0.8	0.8	0	0.8	0.8
Oceania	0.3	2.4	2.1	0.4	2.7	2.3
Subtotal	15.5	9.3	-6.2	14.1	9.0	-5.1
<u>Developing</u>						
Latin America	1.7	12.0	10.3	0.6	13.4	12.8
North Africa/Middle East	4.4	0	-4.4	4.8	0.4	-4.4
East Asia	2.0	2.6	0.6	1.8	2.9	1.1
South Asia	0.6	0	-0.6	1.9	0	-1.9
Asian Centrally Planned	1.1	0.7	-0.4	1.9	0.3	-1.6
Other Oceania	0	0.4	0.4	0	0.4	0.4
Sub-Saharan Africa	1.3	1.6	0.3	1.2	1.5	0.3
Subtotal	11.1	17.3	6.2	12.2	18.9	6.7
TOTAL	26.6	26.6	0	26.3	27.9	1.6

Source: ISO.

Because the production and trade policies of both importers and exporters are fundamentally important to the world sugar supply and demand outlook, the policies of the major exporters and imports are examined in the following section.

SUGAR POLICIES AND THEIR IMPACTS

Structure of World Trade

Six exporters dominate world sugar trade (Table 4). They are relatively large producers and have complex incentive policies to regulate production, consumption and trade.¹ With the exception of the Philippines, they have increased exports sharply over the past decade. They had 57 percent of world trade in 1975 and about 72 percent in 1985, the result of conscious policies to increase their market shares.

Table 4. Six Largest Sugar Exporters, Total Exports

Country	1975	1980	1981	1982	1983	1984	1985	Increase 1975-85
million metric tons, raw value								
Cuba	5.7	6.2	7.1	7.3	6.8	7.0	7.5	18
EEC	0.5	4.5	5.4	5.6	4.9	4.4	4.3	514
Brazil	1.7	2.7	2.7	2.8	2.7	3.0	3.2	89
Australia	2.0	2.4	3.0	3.5	2.4	2.8	3.2	57
Thailand	0.7	0.5	1.2	2.0	1.4	1.4	1.8	157
Philippines	0.0	1.8	3.3	3.3	3.0	3.2	0.7	90
World Total	10.8	26.8	30.1	30.4	28.8	28.4	27.9	35

Source: ITC.

World sugar imports are concentrated also, with 48 percent of the total going to five important nations (Table 5). In these markets, consumption increases generally have been slower than production growth, and imports have declined as a result. The world sugar trade grew by more than two-fifths

¹ All major exporters guarantee minimum producer prices. Most control exports and amounts available for domestic consumption. Some exporters prohibit imports. Both exporters and importers restrict imports by taxing them. The EEC, for example, guarantees producer prices, applies prohibitive levies to imports (except limited amounts from former colonies), and subsidizes exports as necessary to compete. The centrally planned economies including Cuba have even tighter controls over investment, consumption, exportation, and consumer prices. The EEC and Japan both restrict HFCS production.

during the period 1975-82 but has moved downward since that time. Among the 17 or so importers, only the USSR and China have increased their reliance on the world markets during the last decade.

Table 5. Five Largest Sugar Importers, Total Imports

Country	1975	1980	1981	1982	1983	1984	1985	Increase 1975-85
million metric tons, raw value								
USSR	1.3	5.0	5.2	7.4	4.0	3.3	4.9	53
U.S.	3.5	3.8	4.8	2.4	2.1	3.0	2.1	-20
Japan	2.5	2.3	1.8	2.2	1.9	1.9	1.9	-24
China	0.5	0.9	1.2	2.0	1.0	1.3	1.7	407
EEC	2.2	1.4	1.4	1.5	1.5	1.7	1.5	-32
World Total	10.8	26.8	28.2	29.4	27.5	27.9	26.3	28

Source: ITC.

During the 1970s, both importing and exporting nations developed incentives to increase production with dramatic results.² In every major nation or producing region except the United States, area devoted to sugar production was increased significantly. Brazil (a major exporter) and China (a major importer) undertook massive increases in area which accounted for nearly one-third of the world's 25 percent increase. Thailand mounted a similar effort and more than tripled its sugar area. The EEC increased its area 30 percent. But in addition to those very large changes was a general pattern of substantial increases in every major nation or producing region except one, the United States.

Essentially all of the increase in world sugar production through the 1970s was due to expansion in area. Production at the end of the decade was

² A detailed discussion of the policies of the major importers and exporters together with recent production, consumption, and trade is presented in Appendix II.

24 percent higher than at the beginning and increase in area was 73.4 percent. In every case, domestic policies have been a major factor in the increases in area devoted to sugar production.

The results of the widespread intervention in world sugar markets have been twofold. Internal price structures that stimulated production have dampened consumption growth at the same time. Stocks were increased and, in addition, the free market was used as a dumping ground. Even as prices declined through the early 1980s, many countries continued to expand production for export in an effort to generate badly needed foreign exchange.

In addition, bilateral and multilateral agreements were designed to help stabilize supplies and prices and, increasingly, to insulate producers and consumers.

Trade Agreements

Many importers have attempted to assure their sugar supplies by bilateral agreements with established prices. About 9.2 mmt of sugar were traded under such agreements in 1984 with the Cuba-USSR agreement the largest. For example, Cuba has agreements with the USSR, China, East Germany, and Bulgaria, and sold a total of 5.6 mmt under those arrangements in 1984. Under agreements deriving from the accession of the United Kingdom into the EEC, the ACP (African, Caribbean, and Pacific) signatories of the 1975 and 1979 Lome' Conventions are permitted to export about 1.4 mmt of raw sugar to the EEC annually at preferential prices.

Nations that trade sugar have been attempting to develop multilateral trade agreements to reduce price instability for many years. Since World War II, four International Sugar Agreements (ISAs) have attempted to unite producing and consuming nations to insure adequate supplies and more stable

prices. More than 160 countries trade sugar with some degree of regularity, and all but two of the major importers and exporters--the EEC and China--were members of the most recent 1977 Agreement, the most elaborate effort yet. Although extended for 2 years beyond its original 4-year life, that Agreement expired at the end of 1984. Repeated attempts to agree to economic provisions for a new Agreement ended in failure in mid-1984 and the subsequent 1985 Agreement has no trading or stocking restrictions.

The United States became a full member in 1980, following most of the other important sugar exporters and importers, including Cuba and the USSR. Nevertheless, the 1977 Agreement did not stabilize prices within the target range for at least three reasons. The world's second largest free market exporter, the EEC, was not a member and maintained policies counter to those of the ISA. Second, the amounts specifically controlled by the Agreement were too small. Finally, the Agreement did not have adequate means to adjust exports to changing market conditions, for example increasing production of high fructose corn sweeteners (HFCS) or low calorie sweeteners.

About 60 percent of the world's sugar production and nearly half of consumption take place in just ten large nations who also account for 72 percent of the exports and 48 percent of the imports. Six of the ten are primarily exporters and four are importers. Each intervenes directly in sweetener markets, and most regulate both producer and consumer prices (Table 6).

Table 6. Summary of Policies of Major Exporters and Importers

Item	1985 Shares of World : Trade : percent	Price Policies	Trade Policies
Exporters			
Australia	10	Fixed Producer Price; Production Quota	Sales by Quasi-Government Corporation
Brazil	11	Minimum Producer Price; Maximum Mill Price	Sales by Quasi-Government Corporation
Cuba	26	Administered Prices and Production	Government Sale
ECG	15	Producer Price Guarantees; Import Regulation	Export Subsidies
Philippines	3	Regulated Producer and Retail Prices	---
Thailand	7	Regulated Producer, Retail, and Export Prices	Government Controlled Sales
Total	72		
Importers			
China	6	Administered Prices	Government Purchase
Japan 1/	7	Minimum Producer Prices; Import Levies	Import Levies
United States	10	Raw Sugar Price Support; Import Restrictions	Duties, Fees, Quotas
USSR	19	Administered Producer and Consumer Prices	Government
	42		

1/ Japan subsidizes the price of domestic sugar production, and finances part of that cost through import fees on both corn sweeteners and sugar (in excess of quarterly determined amounts). A surcharge is applied to corn sweeteners to generate revenue and to discourage substitution for sugar.

Source: USDA.

IMPACTS OF U.S. SUGAR POLICIES SINCE 1982

The 1981 Program

Between 1948 and 1974, U.S. sugar policy was embodied in a series of sugar acts which stabilized domestic prices through country-by-country import quotas. Since 1974, U.S. policy has been erratic and involved a number of programs. For two periods, 1974 to 1977 and 1980 to 1981, there was no U.S. sugar price support program and domestic prices followed world price movements very closely. Congress mandated price supports for the 1977 and 1978 crops and wrote sugar price support provisions into the 1981 farm bill to cover the 1982-85 crops. The current law, the Food Security Act of 1985 (PL 99-1988), closely follows the pattern of the 1981 Act. It mandates sugar price support loans, with the loan level to be at least 18 cents per pound of raw cane sugar for the 1985-90 crops, and at fair and equitable levels for beet sugar. The President is directed to use all available authorities to enable the Secretary to operate the program at no cost to the federal government by preventing CCC accumulation of forfeited sugar.

The 1981 program was designed to depend primarily on fees and duties to stabilize domestic prices. However, because fees cannot exceed 50 percent of the world price and the maximum duty is 2.8125 cents per pound (raw value), the market stabilization price (MSP) cannot always be achieved by fees and duties alone when world prices fall. Since May 1982, a system of country-by-country quotas has been maintained. The base quota for the year beginning December 1, 1985 was 1.68 mmt.

While the U.S. sugar policy protects producers from low world prices, there is no policy objective to become self-sufficient in sweeteners as the EEC did, and as is the case in Japan and other major sugar importing nations.

Furthermore, U.S. price support programs have resulted in domestic prices generally below national average production costs. U.S. production declined after the 1974-75 period of extremely high world prices and has become relatively stable since 1980.

Performance of the U.S. Industry

The 1981 program was implemented early in 1982. In spite of extremely unstable world prices, domestic sugar production has stabilized at about 5.4 mmt, raw value. HFCS production continued the expansion begun in the 1970s and reached 5.0 mmt, raw value, in 1985 (Table 7). Imports declined to 2.5 mmt.

Through FY 1984, domestic market prices for sugar exceeded the MSP.¹ As a result, all loans were repaid with interest, no sugar was forfeited under the price support loan program, and CCC net loan outlays were zero. However, in the 1985 marketing year, 391 thousand metric tons (tmt) of sugar was forfeited in Florida and Colorado. CCC sold 115.3 tmt of that to be made into alcohol fuel and 96.8 tmt for food uses. By mid-1986, CCC continues to hold 160 tmt.

¹ The MSP is calculated by USDA on the basis of the price support loan rate and is the domestic price necessary to provide adequate incentive for repayment of CCC loans.

Table 7. U.S. Sugar and HFCS Production and Prices

Item	1981	1982	1983	1984	1985
-- million metric tons, raw value --					
<u>Production</u>					
Sugar	5.8	5.4	5.2	5.3	5.4
HFCS	2.6	3.0	3.5	4.2	5.0
Net	8.4	8.4	8.7	9.5	10.4
<u>Imports</u>					
Sugar	4.6	2.7	2.8	3.2	2.5
-- cents per pound --					
<u>Prices</u>					
Refined Sugar 1/	29.0	27.6	26.1	25.7	23.2
HFCS	23.6	18.8	21.1	22.7	20.0
Raw Sugar	19.7	19.9	22.0	21.7	20.3
MSP 2/	19.1	20.7	21.2	21.6	21.5

1/ Refined sugar, Chicago West prices.

2/ The MSP is calculated by USDA on the basis of the price support loan rate and is the domestic price necessary to provide adequate incentive for repayment of CCC loans.

Source: USDA and ISO.

Responses to Low World Prices

The 1981 program was enacted at an especially turbulent time. World economic growth that had been rapid although erratic during the 1970s declined very sharply during the early 1980s. In developing countries, large debt payments became increasingly difficult as economic growth slowed. Sugar sales for scarce foreign exchange became increasingly vital, just as weakening economies diminished most of the world's ability to buy. The industrial nations' anti-inflationary policies sharply increased the value of the dollar and simultaneously weakened the currencies of most of the rest of the world.

Starting in 1981, a series of abundant crops increased stocks for 4 successive years as production exceeded consumption by 18.9 mmt. Prices came under extreme pressure.

In this economic context, world sugar importers and exporters were unable to renegotiate the expiring 1977 International Sugar Agreement at the end of 1984. Not only were exporters then free from their obligation to hold stocks, but they were given an incentive to maintain export market shares in spite of low prices against the possibility that actual exports might become the basis for allocating future shares. World prices plummeted to record lows.

In 1984, the world raw sugar price averaged about 5.2 cents per pound, FOB the Caribbean. Year-end stocks were more than 54 percent of consumption. Even in the face of such a negative economic outlook, in 1985 four of the six major exporters increased production and Cuba, Brazil, Australia, and Thailand increased exports. The EEC reduced exports by 0.7 mmt while the Philippines' reduction was 0.3 mmt (Table 8).

In spite of the very low world prices, the principal sugar importers either reduced imports or held them steady because their growing production or declining demand reduced their needs.

Table 8. Major Exporters and Importers' Reactions to Low Sugar Prices

Exporters	Production:	Net Exports	Importers	Production:	Net Imports
	mmt			mmt	
Cuba			USSR		
1983	7.5	6.8	1983	8.8	5.9
1984	7.8	7.0	1984	8.8	5.5
1985	7.8	7.3	1985	8.8	4.7
% Change 1/:	4.0	7.4	% Change 1/:	0	-17.0
EEC			U.S.		
1983	12.3	4.9	1983	5.2	2.8
1984	13.3	4.4	1984	5.3	3.2
1985	13.4	4.2	1985	5.4	2.5
% Change 1/:	8.9	-14.3	% Change 1/:	3.8	-10.7
Brazil			Japan		
1983	9.6	2.8	1983	0.8	1.9
1984	9.3	3.0	1984	0.8	1.9
1985	8.8	3.2	1985	0.9	1.9
% Change 1/:	-8.3	14.3	% Change 1/:	12.5	0
Australia			China		
1983	3.3	2.4	1983	3.9	1.7
1984	3.6	2.6	1984	4.3	1.2
1985	3.6	2.7	1985	4.7	1.6
% Change 1/:	9.1	12.5	% Change 1/:	20.5	-5.9
Thailand					
1983	2.1	1.4			
1984	2.5	1.4			
1985	2.6	1.8			
% Change 1/:	23.8	28.6			
Philippines					
1983	2.1	1.0			
1984	2.6	1.2			
1985	1.4	0.7			
% Change 1/:	-33.3	-30.0			

1/ 1983-85 change.

Source: ISO.

Impacts on Domestic Production and Consumption

The degree to which the U.S. sugar policy stabilized the domestic industry during this turbulent period can be seen by comparing production, consumption, and prices that occurred with those that might reasonably have been expected in the absence of a program (Table 9).

Table 9. Impact of the 1981 Sugar Program: U.S. Sweetener Production, Consumption, and Prices

Item	1981		1982		1983		1984		1985	
	Actual	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program
	1/	1/	1/	1/	1/	1/	1/	1/	1/	1/
-- million metric tons, raw value --										
Production										
Sugar	5.8	5.8	5.4	5.3	5.2	4.3	5.3	2.8	5.4	2.0
HFCS	2.6	2.6	3.0	3.0	3.5	3.3	4.2	3.6	5.0	3.6
Imports										
Sugar	4.6	4.6	2.7	3.3	2.8	4.7	3.2	6.0	2.5	7.2
Consumption										
Sugar	9.0	9.0	8.3	8.7	8.1	8.7	7.7	8.6	7.5	9.0
HFCS	2.6	2.6	3.0	3.0	3.5	3.3	4.2	3.6	4.8	3.6
Total	11.6	11.6	11.3	11.7	11.6	12.0	11.9	12.2	12.3	12.6
-- cents per pound --										
Prices										
Raw Sugar	19.7	19.7	19.9	11.8	22.0	12.0	21.7	13.0	20.3	14.4
Refined Sugar 2/	25.6	25.6	25.8	17.1	28.1	17.4	27.8	18.4	26.2	19.9
HFCS	23.6	23.9	18.8	11.3	21.1	12.0	22.7	14.0	20.0	15.0

1/ Raw sugar prices are calculated to be the world price plus transportation costs plus duties on imports not eligible for CBI or GSP exemptions; for example, the 1985 landed U.S. price would consist of a 10.5 cents per pound world price, 1.5 cents transportation cost, and an average duty of 1.5 cents.
2/ Refined sugar prices are calculated on the basis of U.S. raw sugar prices, 7 percent refining loss, and 4.5 cents per pound refining costs.

Source: USDA and ISO.

The initial impact of the absence of the 1981 program would have come through lower prices. Raw sugar prices that averaged 19.7 cents per pound in 1981 would have fallen to 11.8 cents per pound in 1982 based on an 8.8 cents per pound world price, and stabilized just above that level.

Even though the raw sugar price declines would have been large and persistent, they would have been expected to reduce retail food prices by relatively small amounts. Annual sweetener consumption would have increased slightly, as much as 0.5 mmt after 4 years.

The impact of the low prices on domestic sweetener production would have been immense. Raw and refined sugar prices would have been below average variable production costs in all U.S. regions. Production would have declined

slightly in 1982, but high cost plants would have begun closing by the next year. The low sugar and HFCS prices also would have put severe economic pressure on HFCS producers. By late 1981, planned and operational HFCS production capacity was nearly 4.9 mmt. A more than 40 percent decline in HFCS prices from those expected in 1982 would have sharply limited expansion in subsequent years even though the HFCS price probably would have continued above the variable cost of production. Some of the highest cost existing plants likely would have closed, and part of the planned expansion cancelled within 12 to 18 months. HFCS production that was about 85 percent of industry capacity in 1985 would have been reduced, perhaps by 1.5 mmt.

In contrast to the current situation where the sugar industry faces cost and price competition from the domestic HFCS industry, the U.S. sugar industry would have faced near elimination in the absence of the 1981 program. Those firms who were able to reduce their costs to minimal levels and to persuade producers to sell sugarbeets and sugarcane for sharply lower prices would have had the best chance of continuing to produce. In the absence of such a strategy, sugar production in the United States would have declined to near zero.

Similarly, HFCS producers would have faced severe uncertainty and very difficult management problems. It would have been necessary to design operating strategies in the expectation of continuing below full cost for several years. Decisions would have depended heavily on expectations about corn prices. Higher prices would have meant increased production costs and smaller incentives to produce with returns below the cost of production. Economic pressure to close higher cost plants would have increased sharply.

Impact on World Markets

In spite of the severe impacts on the U.S. sweetener industry, the absence of the U.S. sugar programs would have increased sweetener consumption only slightly. It would have increased sugar consumption by slowing HFCS production growth, but all of the additional sugar use would have come from imports. World sugar prices would have been somewhat stronger as a result.

The United States produced more than 5 percent of the world's sugar in 1982. The impact of the absence of the 1981 sugar program on the world market would have been very small for at least the first 2 years, but would have grown as U.S. production declined and imports increased. By 1983, the increase in trade would have been enough to reduce the very high world stocks levels moderately and raise world prices about 1 cent per year, in spite of expected production increases in Brazil and smaller increases by other exporters. By the end of 1985, with U.S. production at only 2.0 mm, raw prices in the world market likely would have been about 11.4 cents per pound, 3 cents above 1982 levels (Table 10).

While world sugar production and consumption totals would have been little different in the absence of the U.S. 1981 program, the beneficiaries would be very different. The primary losses from such a change would have accrued to U.S. agricultural producers and the U.S. government.² The primary gains would have gone to the EEC (in the form of reduced export subsidies), Cuba, Brazil, and the other major sugar exporters.

² The government would have higher expenses in the form of increased CCC costs resulting from the weaker demand for HFCS and lower corn prices as a result. These would be partly offset by increased revenues from duties on the increased amounts of sugar imports.

Table 10. Impact of the U.S. Sugar Program on World Supply, Use, and Prices

Item	1981		1982		1983		1984		1985	
	Actual	No Program	Actual	No Program	Actual	No Program	Actual	No Program	Actual	No Program
	-- million metric tons, raw value --									
Production	92.5	92.5	101.4	101.3	96.9	96.6	99.2	97.2	98.1	96.0
Consumption	89.5	89.5	92.3	92.6	93.5	93.8	90.2	90.0	90.2	90.0
Ending Stocks	40.6	40.6	47.1	46.6	49.3	48.2	51.7	48.0	48.6	46.0
	-- percent --									
Stocks/Consumption	45.3	45.3	51.0	50.5	52.5	51.4	53.7	50.0	49.5	46.9
	-- cents per pound --									
World Raw Sugar Price	10.9	10.9	8.4	8.6	8.5	9.0	5.2	10.0	4.0	11.4

Source: USDA and ISO.

Such a policy change in the United States would have had extremely serious consequences for U.S. sugar and HFCS producers. During the 4 years 1982-85, it would have reduced sales of U.S. sugar, HFCS, and corn by \$10.5 billion. It would have increased government farm program costs net of increased revenues from sugar imports by \$1 billion. By contrast, it would have increased revenues for the world's major exporters, with the lion's share going to those nations who held export levels high through government intervention. Major exporters' sugar revenues would have been increased by \$5.4 billion, with 30 percent of the increase going to the EEC and 11 percent to Cuba.

Impact on Caribbean Exporters

While the primary benefits of the U.S. sugar program flow to U.S. producers of sugar, HFCS, and corn, the program also is important to sugar exporting nations of the Caribbean region. These nations are small, have low

incomes, and depend heavily on sugar production for employment and foreign exchange. Traditional exporters with climates well suited for the production of raw cane sugar, they produce between 3 and 4 mmt of raw sugar annually and export most of their production (Table 11). The United States and the EEC are by far the region's most important markets (Table 12).³

Table 11. Caribbean Sugar Exporters, 1985 1/

Nation	Production	Exports	Exports to the United States
	-- thousand metric tons --		
Barbados	98	82	16
Belize	102	85	13
Costa Rica	230	58	15
Dominican Republic	850	740	367
El Salvador	280	90	54
Guatemala	533	300	88
Guyana	265	220	8
Haiti	47	11	5
Honduras	212	104	20
Jamaica	193	144	26
Nicaragua	251	97	---
Panama	175	86	59
Trinidad	82	64	16
Other	35	35	5
Total	3,353	2,116	692

1/ Sugar exporting nations included in Caribbean Basin Initiative programs.

Source: USDA.

The two largest exporters of the region (except for Cuba which is not eligible to export to the United States) are the Dominican Republic and

³ The Caribbean Basin Economic Recovery Act was initiated in 1984 to provide aid and trade assistance to 27 countries in Central America, northern South America, and the Caribbean. A major feature of this program is duty free access to U.S. markets for products produced in the region, including sugar. However, U.S. import quotas restrict the amounts of sugar that can be entered into the United States.

Guatemala who account for nearly 40 percent of production but almost half of the region's exports. Both have large U.S. quotas.

The region's sugar industry expanded production rapidly following the high prices of 1974-75, and many of its firms have large debts and high production costs as a result. Nevertheless, production continued to grow until 1982, long after rising world stocks pushed prices below returns.

Table 12. Caribbean Sugar Revenues

Year	Total Exports	Export Revenues from Sales in:				Total
		U.S.	EEC 1/	Rest of World		
	(tmt)				-- million dollars --	
1983	2,521	448	180	200	827	
1984	2,287	561	151	71	783	
1985	2,116	287	148	87	522	

1/ Under an arrangement deriving from the accession of the United Kingdom into the EEC, the 13 signatories of the Lome' Agreement of 1975 are permitted to sell about 1.4 mmt of sugar annually in the EEC at highly preferential prices, the same prices guaranteed EEC producers for "A" quota sugar.

Source: ISO.

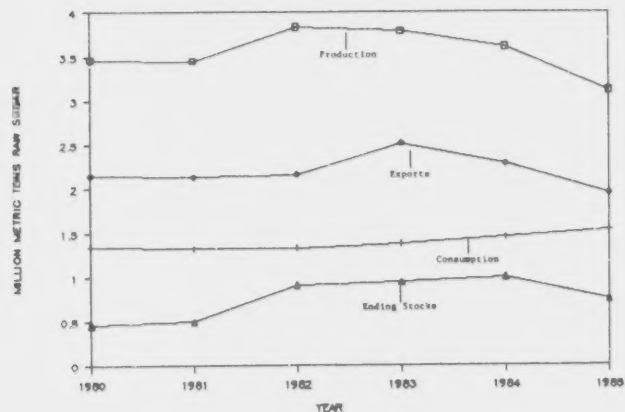
In 1985, weather problems reduced production in the region and reduced stocks somewhat, although they are still far above 1980 and 1981 levels (Chart 4).

Both the United States and the EEC have permitted duty-free access to domestic markets for quota sugar from selected Caribbean producers. Barbados, Belize, Jamaica, Guyana, Panama, Suriname, and Trinidad-Tobago have EEC quotas for a total of 460 tmt of sugar. In calendar year 1985, all exporters in the region except Cuba and Nicaragua had U.S. quotas for a total of 692 tmt.

These special markets are extremely important to the region, even though they are declining in size. They accounted for 54 percent of its sugar export

tonnage in 1985 and 83 percent of its sugar export revenues. The EEC reduced imports from the Caribbean in 1984 from 484 tmt to 460 tmt in an effort to reduce the more than \$1 billion cost of the export subsidies it requires to sell its 3.7 mmt (raw, equivalent) of subsidized refined sugar exports. There is strong economic pressure within the EEC to continue to reduce these sugar imports and apply production and import levies.

Chart 4. Caribbean Sugar Production, Exports, Consumption, and Stocks, 1980-85



In the United States, the 1985 farm bill mandates minimum price support loan levels and requires that the program be operated at no federal cost. To comply, the government must hold domestic supplies small enough to insure prices that make it profitable to redeem sugar under CCC loan rather than

forfeit it. Thus, the declining demand for sugar in the United States has meant the need to tightly restrict sugar imports.⁴

The Caribbean sugar exporters are under serious economic pressure. In 1980, the region's major sugar producers had exports worth \$12.2 billion; by 1984, their exports had a value of \$8.9 billion and in 1985, \$7.9 billion.

Sugar is important to the region, but only five of the thirteen depend on sugar for more than one-sixth of export revenues and, for the region as a whole, sugar accounted for a relatively small share of total export sales in 1980--8 percent.⁵ In addition, revenues from sugar exports have fallen less rapidly than those from other products. Sugar accounted for 8.5 percent of export revenues in 1984, a larger share than in 1980.

Such observations do not, of course, minimize the impact of the decline in sugar prices on the region. They do emphasize the fact that the region's economic problems have many sources and will require comprehensive efforts to overcome the region's \$4.3 billion total export revenue loss (Chart 5). Sugar export revenues that were \$871 million in 1980 averaged about \$706 million for the 3 years 1983-85, a loss of \$165 million.

In this context, the U.S. sugar program is extremely important to the region. For the last 3 years, prices of sugar sold in the United States have averaged 19.9 cents per pound, while that sold on world markets averaged 6.1

⁴ While the base sugar quotas have been reduced from 2.8 mmt, raw value, for FY 1983 to 1.71 mmt for the quota year beginning December 1, 1985, substantial additional amounts are entered indirectly, especially through foreign trade zones in the United States where sugar purchased at world prices is manufactured into sugar-containing products for sale in the United States, and through imports of sugar-containing products.

⁵ The five Caribbean nations that depend most heavily on sugar for export revenues are: Barbados, Belize, the Dominican Republic, Guyana, and Panama.

cents per pound (Table 13). Had there been no U.S. program, the loss of the favorable prices in U.S. markets would have reduced the region's sugar export revenues by \$60 million.

Chart 5. Values of Caribbean Exports, 1980-84

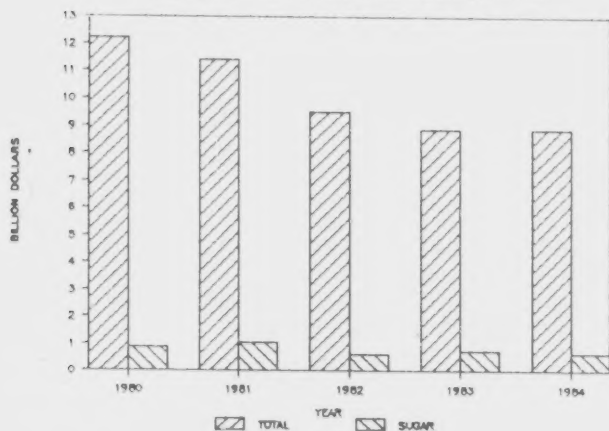


Table 13. Impact of U.S. Program on 13 Largest Caribbean Sugar Exporters

Destination	Actual 1/			No U.S. Program, 1985		
	Amount	Price	Revenue	Amount	Price	Revenue
		2/			2/	
	(tmt)	(cents/lb)	(mil \$)	(tmt)	(cents/lb)	(mil \$)
United States	979	19.87	432.0	1,500	11.40	377.0
EEC	468	15.43	159.5	460	14.59	148.0
Rest of World	861	6.14	119.3	500	11.40	125.7
Total	2,308		710.8	2,460		650.7

1/ Average amounts and prices for 3 years (1983-85).

2/ Prices FOB Caribbean ports.

In the absence of the U.S. program, total sugar exports from the region would have been slightly higher, about 2.5 mmt rather than 2.3 mmt averaged during the last 3 years. However, the decline in U.S. prices would have reduced the average price by nearly \$44 per ton. Thus, in spite of a 53 percent increase in shipments to the United States, revenues from U.S. sales would have been 13 percent lower. The lower average price for all markets would have meant about \$60 million less revenue for the region from the sale of 7 percent more sugar.

The recent export revenue declines in the Caribbean arise from price declines for many commodities, in addition to sugar. And, the problems in the world sugar economy are the result of policies of sugar producers and consumers worldwide. For these reasons, the absence of the U.S. sugar program would have left the region's severe economic problems virtually unchanged. While world prices would have improved, not only would sugar revenues in the Caribbean exporting nations have declined, but they would have continued to be below production costs for most producers. As long as world prices are held at low levels by the production, consumption, and export policies of the world's large exporters, Caribbean sugar export revenues will continue under heavy pressure.

APPENDIX I. WORLD SUGAR CONSUMPTION AND PRODUCTION BY REGION

Table I-1. Sugar Consumption

Item	1984/85	1985/86	Absolute Change	Percent Change
-- million metric tons --				
Europe	34.37	35.08	0.71	2.07
EEC-12	11.82	12.04	0.22	1.86
North America	8.60	8.20	-0.40	-4.65
United States	7.60	7.20	-0.40	-5.26
Central America	5.69	5.77	0.08	1.41
South America	10.68	10.97	0.29	2.72
Asia	29.21	30.63	1.42	4.86
China	5.83	6.54	0.71	12.69
Japan	2.77	2.70	-0.07	-2.53
India	8.70	9.00	0.30	3.45
Africa	8.04	8.27	0.24	2.86
South Asia	1.41	1.45	0.04	2.84
Oceania	1.04	1.04	---	---
WORLD	97.62	99.95	2.33	2.40

Source: World Sugar Journal.

Table I-2. Sugar Production

Item	1984/85	1985/86	Absolute Change	Percent Change
-- million metric tons --				
Europe	31.61	31.62	---	---
EEC-12	14.31	14.55	0.24	1.7
USSR	8.80	8.75	-0.05	-0.6
North America	5.42	5.41	---	---
United States	5.30	5.32	---	---
Central America	14.32	13.34	-0.98	-6.8
Mexico	3.05	3.50	0.45	7.9
Cuba	8.10	7.00	-1.10	-13.6
Dom. Rep.	0.90	0.70	-0.20	-22.2
South America	14.21	12.67	-1.54	-10.8
Brazil	9.13	7.70	-1.43	-15.7
Asia	21.18	22.61	1.43	6.8
China	4.53	5.13	0.60	13.2
India	6.70	7.20	0.50	7.5
Philippines	1.40	1.30	-0.10	-7.1
Thailand	2.51	2.70	0.20	8.0
Africa	7.57	7.39	-0.18	-2.4
South Africa	2.55	2.30	-0.25	-9.8
Oceania	4.14	3.84	-0.30	-7.2
Australia	3.62	3.40	-0.22	-6.1
WORLD	98.44	96.87	-1.63	-1.6

Source: World Sugar Journal.

APPENDIX II. SUGAR POLICIES OF MAJOR EXPORTERS AND IMPORTERS

The European Economic Community

The EEC, a traditional importer, has become the world's largest exporter to the free market, the result of a conscious policy that depends upon administered prices and very costly export subsidies. The EEC's sugar regime maintains a structure of high consumer prices, high producer prices, and export subsidies which stimulate production and diminish consumption (Table II-1). The effective support price for 1985/86 sugar is \$25.7 per hundredweight (cwt) of refined sugar.¹ In early 1986, the export restitution payment was \$19 per cwt for quota exports.

The policy is extremely complicated. Three categories of production quotas are used, each with different price supports, production levies, storage payments, and export subsidies. Relatively heavy production levies are applied on "B" quota sugar in an effort to help control production and finance the program. However, the program's accumulated cost deficits are about \$387 million. As a result, the co-responsibility levy on "B" quota production has been increased for the 1986 and 1987 crops to help reduce this deficit. Imports are discouraged by high import levies.

When world prices are low, the EEC subsidizes sugar exports as necessary to avoid holding large stocks. When prices are high, it taxes exports in an effort to maintain its own supplies, policies that amplify price swings in an already unstable world sugar market.

¹ As of May 1, the 58.43 ECU per 100 kg effective support rate had increased to \$25.50 per pound. The increase was the result of the value of the ECU against the dollar. In March 1985, the value of the ECU was \$0.675. By March 1986, it was \$0.954 and growing.

Although the EEC's program is formally based on the government's commitment to buy all sugar produced within the "A" and "B" quotas at announced prices, it actually maintains high internal prices by systematically diverting sugar into world markets. Since subsidies as large as 80 percent of the domestic price are required to export into depressed world markets, the program has become increasingly costly. In 1985, the EEC accounted for 16 percent of world sugar exports.

Table II-1. EEC: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	13.5	15.5	15.5	12.3	13.3	13.4
Consumption	11.0	10.6	10.7	10.5	10.7	10.5
Net	2.5	4.9	4.8	1.8	2.6	2.9
Imports	1.4	1.4	1.5	1.5	1.3	1.5
Exports	4.3	5.4	5.6	4.9	4.4	4.2
Net Exports	2.9	4.0	4.1	3.4	3.1	2.7

Source: ISO.

The high cost of the sugar regime's export subsidies has generated pressures for change, both within the EEC and among its trading partners. Nevertheless, the production quotas are to remain unchanged for the 1986 and 1987 crops, while a small increase in the quota sugar production levies will be applied. Such changes do not fundamentally change EEC sugar policies. Strong political support for the region makes the continuation of high levels of EEC exports highly likely.

Japan

Japan is a very large importer whose policies have been directed toward achieving sweetener self-sufficiency through increased domestic sugar and HFCS

production. Import regulation and production subsidies are used to restrict consumption and stimulate production. Producer prices are the highest in the world. Even though per capita use is relatively low compared to other developed countries and has been declining since 1981, consumption has remained fairly stable due to population increases (Table II-2). Domestic sugar production is limited and Japan imports two-thirds of the sugar it consumes.

Table II-2. Japan: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	0.8	0.8	0.8	0.8	0.8	0.9
Consumption	3.0	2.7	2.9	2.8	2.8	2.8
Net	-2.2	-1.9	-2.1	-2.0	-2.0	-1.9
Imports	2.3	1.6	2.2	1.9	1.9	1.9
Exports	1/	1/	1/	1/	1/	1/
Net Exports	-2.3	-1.6	-2.2	-1.9	-1.9	-1.9

1/ Less than 50 thousand metric tons.

Source: ISO.

USSR

Sugar consumption per capita in the USSR has reached 42.3 kg per capita, consistent with their plans. Since further growth in per capita consumption is not desired, total consumption in the future will likely increase only at about the population growth rate.

Both production and consumption incentives are rigidly controlled by the government, which intends to increase production and reduce imports by increasing investment in beet production, especially in seed quality, management information and equipment, and in bonuses. As a result, imports

which had been increasing rapidly have declined by 34 percent since 1982 to 4.9 mm in 1985 (Table II-3). There is no indication the Soviets plan to divert additional land or other production inputs to sugar, or to produce large amounts of HFCS. As a result, the USSR is likely to continue as a very large sugar importer, relying on bilateral agreements with Cuba and purchases from the world free market as necessary to maintain per capita consumption.

Table II-3. USSR: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	7.3	6.4	7.4	8.8	8.8	8.8
Consumption	12.4	12.5	12.7	13.1	13.0	13.6
Net	-5.1	-6.1	-5.3	-4.3	-4.2	-4.8
Imports	5.0	5.2	7.4	6.0	5.7	4.9
Exports	0.2	0.2	0.3	0.1	0.2	0.2
Net Exports	-4.8	-5.0	-7.1	-5.9	-5.5	-4.7

Source: ISO.

Australia

Australia is a major sugar exporter, with a highly efficient and tightly regulated industry. Policies in general are designed to encourage both exports and domestic consumption. Producer prices are determined by formula, with plantings controlled by a marketing board. All sugar produced becomes the property of the board. A quasi-governmental corporation has been designated the sole marketing agent. Retail prices are maintained at relatively low levels by regulating the amounts available for domestic consumption. Because the sugar industry is strictly regulated, production, consumption, and exports have been very stable (Table II-4).

Table II-4. Australia: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	3.4	3.5	3.7	3.3	3.6	3.6
Consumption	0.8	0.8	0.8	0.8	0.7	0.8
Net	2.6	2.7	2.9	2.5	2.9	2.8
Imports	0	0	0	0	0	0
Exports	2.4	3.0	2.5	2.4	2.6	2.7
Net Exports	2.4	3.0	2.5	2.4	2.6	2.7

Source: ISO.

Brazil

Brazil is a major sugar exporter, and has been increasing both sugar plantings and the use of sugar for nonfood purposes. Consumption is very high, about 50 kg per capita.

The government has a major program to produce alcohol from sugar. More than 9 billion liters of alcohol were produced from the 1985 crop, an amount they expect to increase to 11 billion liters by 1986 but which may be reduced because of the cost of ethanol compared with gasoline. Nevertheless, Brazil is committed to long-term alcohol production and use as a motor fuel and while the alcohol program has become increasingly expensive, it is almost certain to be continued as an important element of the nation's energy policy.

Sugar production is controlled by the government through the Sugar and Alcohol Institute. Each mill has a production requirement, and the government sets grower prices, production and export targets, and maximum selling prices.

Brazil has the capacity to process about 12 mmt of sugar annually, well above the 9.3 mmt produced in 1984. It has policies and land area capable of increasing production, but has begun to encourage smaller production at least

while prices are low. Estimated production in 1985 is for 8.8 mmt as compared to 1983 production levels of about 9.6 mmt but most of the reduction is estimated to be the result of dry weather in 1985 (Table II-5).

Table II-5. Brazil: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	8.3	8.7	8.9	9.6	9.3	8.8
Consumption	6.3	5.9	6.1	5.9	6.2	6.2
Net	2.0	2.8	2.8	3.7	3.1	2.6
Imports	0	0	0	0	0	0
Exports	2.7	2.7	2.8	2.8	3.0	3.2
Net Exports	2.7	2.7	2.8	2.8	3.0	3.2

Source: ISO.

Cuba

Cuban policies are a major uncertainty in the world sugar outlook. Cuba has been planning major expansions in production and exports. All of the 151 sugar mills are state-owned. Additional mills are being built, old mills modernized, and additional area is being irrigated. The government guarantees a fixed price for cane delivered at the mill.

Cuba exports about 90 percent of its production, and is the world's largest exporter, primarily to the USSR and China under special price arrangements that return more than 50 cents per pound sold to the USSR (Table II-6). Current expectations are for the USSR and China to increase production and probably not increase imports, so Cuba's expansion objectives appear inconsistent with its prospects for increased markets. Thus, Cuba faces a large and growing excess supply.

Table II-6. Cuba: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	6.8	7.9	8.0	7.5	7.8	7.8
Consumption	0.5	0.6	0.6	0.7	0.7	0.7
Net	6.3	7.3	7.4	6.8	7.1	7.1
Imports	0	0	0.1	0	0	0
Exports	6.2	7.1	7.7	6.8	7.0	7.3
Net Exports	6.2	7.1	7.6	6.8	7.0	7.3

Source: ISO.

Philippines

The Philippines is a major exporter, and has sought to maximize export income by increasing productivity, rather than area. The government regulates retail and producers prices, exports, and stocks. The industry now has both excess processing capacity and idle anhydrous alcohol plants. The government has announced intentions to reduce production by 1 mmt annually, and much of the reduction in 1985 appears to be the result of the new policy and bad weather.

In addition to bad weather, the Philippines has had severe problems with increasing costs which have diminished production incentives and increased pressure to reduce exports which have declined steadily from 1.8 mmt in 1980 to 0.7 mmt in 1985 (Table II-7).

Table II-7. Philippines: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	2.3	2.4	2.7	2.1	2.6	1.4
Consumption	1.2	1.1	1.1	1.2	1.3	1.2
Net	1.1	1.3	1.6	0.9	1.3	0.2
Imports	0	0	0	0	0	0
Exports	1.8	1.3	1.3	1.0	1.2	0.7
Net Exports	1.8	1.3	1.3	1.0	1.2	0.7

Source: ISO.

China

China is a major importer, but is attempting to increase both area and yields. Sugar production has increased 68 percent since 1980 to 4.7 mmt in 1985 (Table II-8). Consumption increases have been smaller and imports appear to be falling, although the Chinese may continue to import at near current levels because of the importance of sugar to an improved standard of living.

Table II-8. China: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	2.8	3.5	3.7	3.9	4.3	4.7
Consumption	3.6	4.3	5.0	5.5	5.5	6.0
Net	-0.8	-0.8	-1.3	-1.6	-1.2	-1.3
Imports	0.9	1.2	2.6	1.8	1.3	1.7
Exports	0.2	0.1	0.1	0.1	0.1	0.1
Net Exports	-0.7	-1.1	-2.5	-1.7	-1.2	-1.6

Source: ISO.

Thailand

Encouraged by high world prices in 1980 and 1981, Thailand embarked on a program of rapid production and export expansion. However, this costly program has been modified and recent reductions in price supports have been followed by lower production.

Exports increased rapidly in 1981 and 1982, and again in 1985 (Table II-9).

Table II-9. Thailand: Sugar Production, Consumption, and Trade

Item	1980	1981	1982	1983	1984	1985
-- million metric tons, raw value --						
Production	0.8	1.7	3.0	2.1	2.5	2.6
Consumption	0.6	0.6	0.6	0.7	0.7	0.7
Net	0.2	1.1	2.4	1.4	1.8	1.9
Imports	0.1	0	0	0	0	0
Exports	0.5	1.2	2.0	1.4	1.4	1.8
Net Exports	0.4	1.2	2.0	1.4	1.4	1.8

Source: ISO.